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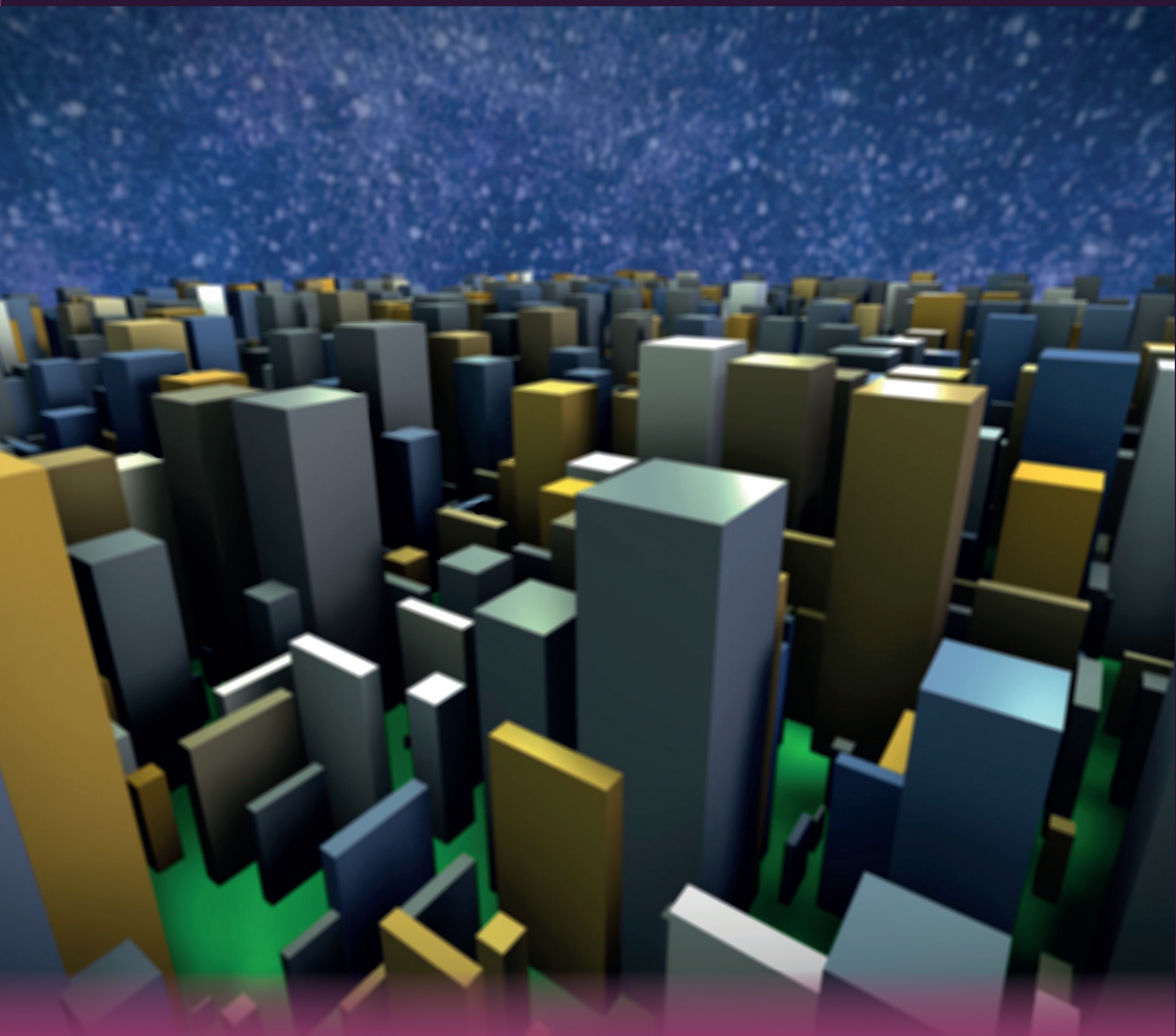
DC scheme investment into Secured Finance assets



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- Provide relevant and accessible information on the extent and nature of retirement provision
- Contribute fact-based analysis and commentary to the policy-making process
- Extend and encourage research and debate on policy on pensions and retirement provision
- Be a helpful sounding board for providers, policy makers and opinion formers
- Inform the public debate on policy on pensions and retirement provision.

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- Independent, with no political bias or vested interest
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- Considering the whole pension framework: state, private, and the interaction between them
- Pursuing both academically rigorous analysis and practical policy commentary
- Taking a long-term perspective on policy outcomes on pensions and retirement income
- Encouraging dialogue and debate with multiple constituencies

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DC scheme investment into Secured Finance assets

Executive Summary

Secured Finance could potentially provide some benefits to large DC schemes if used as part of a diversified portfolio

The profile of Defined Contribution (DC) savers has changed post automatic enrolment, to include many people with lower levels of financial capability, who are likely to be in the default fund. These new DC savers are less likely to have the capability and pot sizes to take informed investment decisions, such as investment into alternative (illiquid and privately listed assets), on their own. However, members of DC schemes could benefit from their pension contributions being invested in alternative assets, if the potential benefits and risks are taken into account on their behalf, by their provider. Building on previous PPI research "DC scheme investment in illiquid and alternative assets", this report looks at the implications of investment into one specific alternative asset, Secured Finance, a type of private credit, though, many other alternative assets could deliver similar benefits and carry similar risks.

Secured Finance could potentially provide benefits to members of large DC schemes if used as part of a diversified portfolio. However, there are increased costs and risks attached to these products and therefore care must be taken to ensure that investment portfolios and members are able to bear the increased risks. Any DC scheme considering this type of investment as part of a move into private credit and other alternative and/or illiquid assets should consider the potential benefits against the potential risks and costs.

Secured Finance investments are investments into private debt instruments

Secured Finance investments, a type of private credit, are typically investments into debt instruments that are separate from traditional investments into loans or bonds on the public market. The significant structural characteristic of Secured Finance investments is that the assets are backed (secured) by collateral in the form of physical collateral (for example, buildings) or financial collateral (for example, pools of mortgages or credits), which can be used to provide a payment in the case of default of the issuer.

Secured assets have the potential to provide higher returns in the long-run compared with similar types of assets, though extra costs and complexities may erode increased returns

Secured Finance investments are intended to generate an extra premium, in return for the illiquidity and the complexity associated with investment in these products. Estimates of the total amount of extra return that could be realised from investment in Secured Finance range between 2% to 6% above comparably rated credit.[1] However, it is difficult to precisely estimate the full gross return from investment in Secured Finance.

Larger schemes are more likely to be able to bear risks and high up-front, and ongoing, costs

Secured Finance investments have high initial and ongoing costs. Larger, cash-positive schemes, such as large master trusts, are more likely to be in a position to lock away a proportion of funds in anticipation of a potentially increased future return. Smaller pension schemes may not have a sufficient investment budget to cover these costs.

Secured Finance could help provide diversification as part of a wider diversified portfolio, though the subject would benefit from further exploration

Diversification and low correlation can assist an investment portfolio in maintaining value in some assets when other assets suffer from loss and can also expose portfolios to the opportunity for higher returns in less well explored areas of the market. However, due to the complexities of evaluating illiquid assets, and the lower levels of transparency, it may be difficult to correctly value the underlying collateral in Secured Finance loans. There is scope for further investigation by independent bodies, such as academics and industry representatives, of the true diversifying potential of Secured Finance.

Schemes need to carefully calculate and keep under review the proportion of liquid funds they would require in the case of a market downturn

Secured Finance investments are generally “locked away” for a period after the initial investment, during which time funds cannot be accessed, or can only be accessed through application or a long period of notice.[2] Restricted access to funds could cause cash-flow problems for DC pension schemes if they have unexpected costs, high levels of transfers out, or if other investments perform poorly and their liquid capital is reduced. In order to avoid needing to gain early access to an illiquid asset, potentially through selling the asset on at a lower than market price, schemes need to carefully calculate and keep under review the proportion of liquid funds they would require in the case of a market downturn. The potential for fund managers to prevent access to illiquid funds is an additional risk that schemes will need to take into account when weighing up the potential benefits and risks of investing.

Secured Finance assets are generally protected from interest rate fluctuations

The main market-risk affecting fixed-income products such as bonds and private credit, including Secured Finance, is that returns do not keep track with rises in interest rates. Returns below interest rate rises can create difficulties with scheme cash-flow management and are likely to represent a loss in fund values, which are expected to rise with interest rates or above. However, the majority of Secured Finance investments provide a floating interest rate[3] which varies with Bank of England central rates.

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1 www.insightinvestment.com/uk/consultants/investment-range/fixed-income/secured-finance/what-drives-returns-in-secured-finance/; Investment Insight (2017); Mercer (2017)
2 Mercer (2017)
3 AXA IM (2019)

While a floating rate will generally keep pace with interest rate rises, they may not always account for other changes in the value of goods and services taking place in the economy, such as rises in property prices (though this is also true for other fixed-income products). Schemes will need to ensure that they are not depending on Secured Finance investments to protect all of their inflation needs, while recognising that income from Secured Finance will generally rise with interest rates.

Those investing in Secured Finance are exposed to some default risk even though these assets are backed by collateral

If the original debtor defaults, claiming back assets may be a costly and complex administrative process and lenders may not always receive back the full value of the investment. This can result in a loss of funds for schemes and their members. DC schemes investing in Secured Finance will need to carefully evaluate the financial health of underlying companies and organisations, in order to ensure that they are not taking undue risk with member's contributions.

Schemes will need to be wary of reputational risk attached to investment in Secured Finance

Sub-prime mortgages, which lay at the foundation of the 2008 financial crisis resemble Secured Finance investments as they are both collections of underlying loans. However, Secured Finance investments reach beyond individual mortgages to a wider range of loans and credit from both individuals and commercial institutions, and are more strictly regulated than sub-prime mortgages were. Despite increases in regulation, members may be wary of schemes investing their contributions into Secured Finance. Schemes will need to be particularly careful when considering the underlying default risk of Secured Finance investments, as loss to fund value may also result in reputational damage.

Introduction

The UK Defined Contribution (DC) world is undergoing radical change. With the introduction of automatic enrolment and the decline of Defined Benefit (DB) provision in the private sector, the majority of future pensioners will rely on a combination of State Pension and DC pension savings to support themselves in retirement. Therefore, the way people save into DC pensions, the way these contributions are invested and methods of access and use in retirement will have a significant impact on the retirement outcomes of future pensioners.

In response, Government and industry have been working to improve the way member contributions are invested. Many schemes are exploring ways of harnessing the potential benefits of adding alternative assets to their investment strategies. Investment in alternative assets, such as infrastructure and real estate (which has grown in popularity worldwide among institutional investors) could offer potential advantages to UK DC schemes' members.

Building on previous research "*DC scheme investment in illiquid and alternative assets*", this report looks into one specific alternative asset, Secured Finance, a type of private credit, though, many other alternative assets could deliver similar benefits and carry similar risks.

Chapter One sets out the reasons that DC schemes are exploring the use of alternative assets and introduces one of these assets, Secured Finance.

Chapter Two sets out the characteristics of DC schemes which could benefit from investment in Secured Finance and explores the potential for these investments to deliver higher returns and portfolio diversification.

Chapter Three considers the risks associated with DC pension scheme investment in Secured Finance.

Chapter One: What is Secured Finance, and why might DC schemes consider investing in it?

Chapter One sets out the reasons that DC schemes are exploring the use of alternative assets and introduces one of these assets, Secured Finance

The profile of Defined Contribution (DC) savers has changed post automatic enrolment, to include many people with low levels of financial capability, who are likely to save over longer time horizons and are likely to be in their scheme's default fund.[4] These new DC savers are less likely to have the capability and pot sizes to take more risky investment decisions, such as investment into alternative (illiquid assets such as infrastructure, real estate and commodities and privately listed assets, such as private debt and private credit), on their own. These assets tend to be illiquid and some can be volatile but provide portfolio diversification and the potential for higher returns over time.

Members of DC schemes could benefit from investment in alternative assets if the potential benefits and risks are taken into account. This report looks at Secured Finance as one of these options.

Secured Finance investments: Secured Finance investments, a type of private credit, are typically investments into debt instruments that are separate from traditional investments into loans or bonds on the public market. The significant structural characteristic of Secured Finance investments is that the assets are backed (secured) by collateral in the form of physical collateral (for example, buildings) or financial collateral (for example, pools of mortgages or credits) which can be used to provide a payment in the case of default of the issuer.

DC savers, post automatic enrolment, have on average, lower levels of financial capability, will be saving over longer time horizons and are more likely to be in the default fund

Automatic enrolment, rolled out between 2012 and 2018, requires all employers to enrol eligible employees into a qualifying pension scheme.[5] By the end of 2019, more than 10.2 million employees were automatically enrolled.[6] The vast majority of these people, 98%, are enrolled into DC schemes.[7] As a result:

- The number of active DC savers has grown from around 5.5m to over 13m over a space of 7 years (2012-2019),[8]
- The value of assets under management in DC schemes has increased from around £350bn in 2012 to around £430bn in 2019 (2019 earnings terms),[9]

4 Silcock *et al*. (PPI) (2019)
5 To be eligible for automatic enrolment an employee must be aged between 22 and State Pension age and be earning £10,000pa or above in at least one job
6 DWP (2020)
7 Silcock *et al*. (PPI) (2019)
8 PPI Modelling, includes those automatically enrolled and those saving prior to automatic enrolment
9 PPI Modelling

- The profile of savers has also changed. Today's DC saver is more likely, on average, to
  - Be invested in their scheme's default strategy,
  - Have a lower income and lower financial capability,
  - Be less capable of bearing risk, due to smaller pot sizes, and
  - Have less access to other (non-DC) private savings and assets during their working life, than yesterday's DC saver.[10]

Today's DC savers are less likely to have the capability and pot sizes to take risky decisions

These new savers are less likely to have the capability and pot sizes to take risky decisions. Therefore, more responsibility falls to the pension provider to ensure that the risks and benefits of default strategy investments are taken into account, alongside the needs and characteristics of members. Alternative assets including Secured Finance, have the potential to offer increased benefits, in exchange for increased costs and risks. Providers face difficult decisions, as they must balance the potential risk against the potential reward on behalf of members who cannot make the decision themselves but who, in the long-term will have their retirement income affected by the decisions made by providers.

Large DB providers have traditionally been more suited to bearing the risk of illiquid and private assets

A growing number of Defined Benefit (DB) schemes are utilising private credit and other illiquid assets as part of de-risking exercises and as a way of meeting future liabilities. These types of investments can be particularly beneficial for pension schemes which need to invest funds with a view to providing income or lump sums to pensioner members decades into the future. DB scheme investment in illiquids is already established and specific interest in the benefits of Secured Finance is growing. Between 2017 and 2018, the proportion of European DB pension schemes investing in Secured Finance strategies grew from just over 0% to 3%, with an average allocation of assets under management of 7%.[11] However, DC scheme take up is still relatively low.

A Secured Finance investment involves the investor directly funding some portion of a loan, with the loan collateral acting as security for the investment

Income from Secured Finance is generally fairly predictable as it generates income from repayments made according to an underlying loan contract. Secured Finance income:

- Is generally less volatile than equity income which fluctuates with market shifts and,
- May be higher than income from Government bonds which is generally limited to public interest rates.[12]

However, investment in Secured Finance costs more than investment in listed bonds and equities and is currently harder for some DC schemes to access due to illiquidity (covered below).

Secured Finance investments have moved beyond the passing on of bank loans to become a more regulated product offered across the market

The original Secured Finance products were loans made by banks to consumers or companies which were then passed on to institutional investors by banks as a way of freeing up more capital to make other loans, and, at times, passing the risk of poor-quality debt onto other investors,[13] these included but were not limited to sub-prime mortgage loans.

10 Silcock *et al*. (PPI) (2019)
11 Mercer (2018) pp. 4, 24 chart 29
12 www.insightinvestment.com/uk/consultants/investment-range/fixed-income/secured-finance/what-drives-returns-in-secured-finance/; Investment Insight (2017); Mercer (2017)
13 AXA IM (2018)

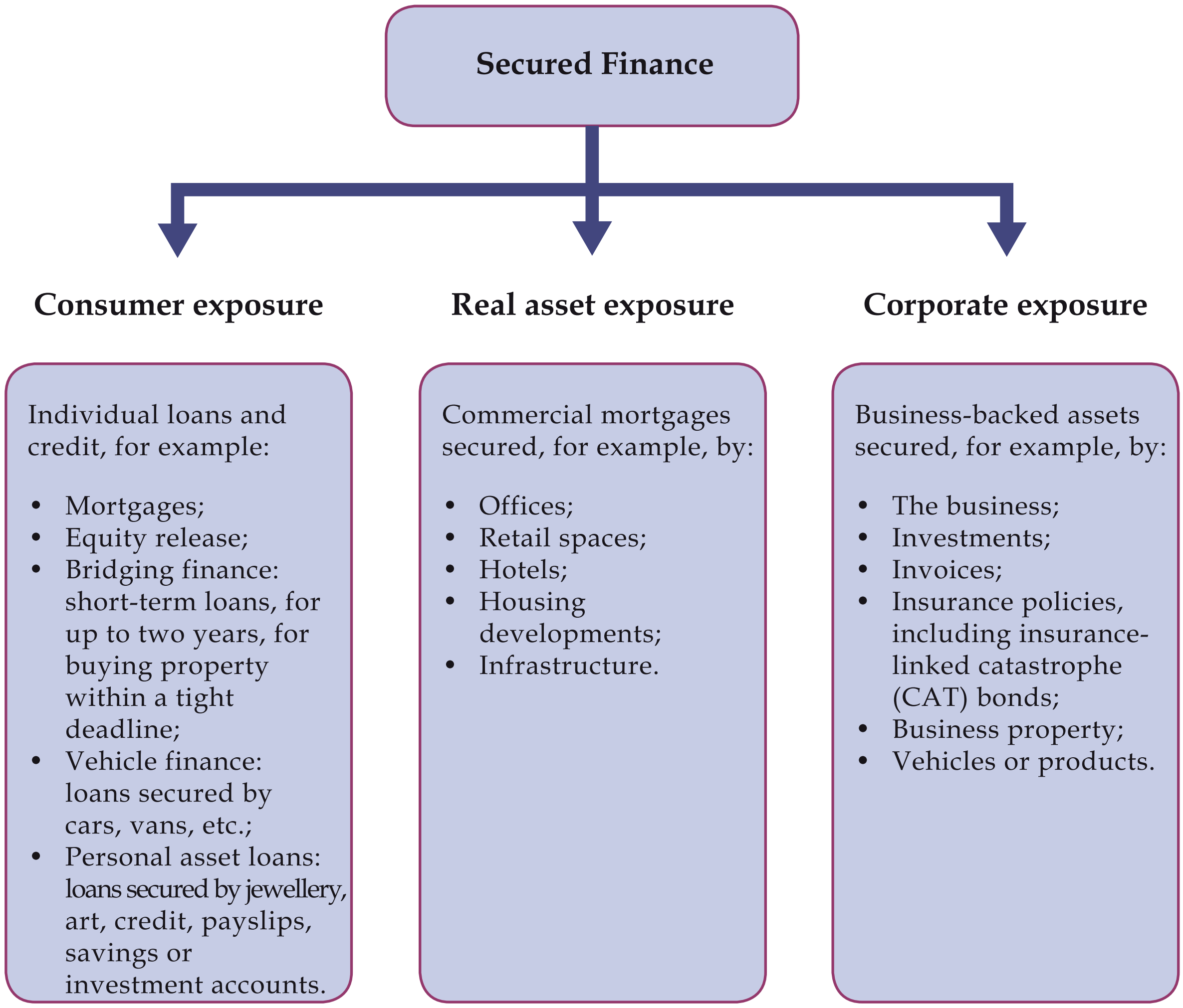
Since this time, the market has moved on and though Secured Finance products may bear some resemblance to the sub-prime mortgage products which underlay the 2008 financial crisis, regulation has been implemented in an attempt to prevent similar problems arising in future. In the EU/UK and US, providers of these products are now required to monitor and report on the quality of underlying loan assets and maintain sufficient liquid capital to prevent significant loss to investors during times of economic stress.[14] It is worth investigation by independent bodies as to whether this regulation has been tested and the extent of protection it provides in practice.

Secured Finance is investment into assets backed by collateral

Secured Finance investments can be broken up into three main types, which are defined by the type of collateral backing (Figure 1.1):

- Consumer exposure
- Corporate exposure
- Real asset exposure

Figure 1.1: Secured Finance investments are typically investments into private debt, loans, and credit with collateral backing



Unlike equities and bonds (which depend on the performance of companies and the liquidity of backing organisations) Secured Finance investments are backed by physical or financial assets[15] which can be repossessed and sold if the borrower defaults on their loan. Therefore, Secured Finance provides an extra, collateral layer of security to investors. Secured Finance investments are intended to provide a rate of long-term return similar to

14 AXA IM (2018)
15 For example, buildings, credit or insurance policies

some other high-return, illiquid assets, and will generally involve lower levels of risk than those associated with, for example, venture capital which is vulnerable to losses in cases of poor company performance, and does not always offer investors physical or financial collateral to secure the investment.

Secured Finance investment products also provide other elements of structural protection which help mitigate risk, though these added layers of protection increase the costs of investing in these assets. For example:

- Seniority provisions, which appoint the investor as the senior creditor in the case of default or bankruptcy;
- First loss provisions, which provide investors with a guaranteed minimum premium in the case of the underlying asset becoming valueless through, for example, criminal loss or natural disaster.
- Leverage covenants, which govern the proportion of funds the original provider can lend to other borrowers, providing some protection against the provider facing financial difficulties which may affect the investors.[16]

Private credit, including Secured Finance, is being accessed by institutional investors and DB pension schemes

Investment into Secured Finance is becoming more popular. Global syndicated lending increased by 8% in 2018, to reach a total value of US$5 trillion, with US$2.5 trillion of this lending taking place in the USA, and US$1.05 trillion taking place in Europe, the Middle East and Asia.[17] In 2017, around 8%, £0.2 trillion of UK institutional investment was in asset backed securities (a type of Secured Finance product) including mortgages.[18]

International DC schemes have also started investing more in private credit, including Secured Finance. In particular, Australian superannuation pension funds are growing increasingly invested in offshore and alternative investments. 72% of Australian Superfunds intend to increase the proportion of their funds invested internationally and many of these funds are particularly interested in increasing their allocations to private debt, infrastructure and real estate.[19] The Australian Superannuation Scheme intends to increase the proportion of assets invested in private debt, infrastructure and real estate from 20% to around 30% over the next three years.[20] However, UK DC schemes have not yet widely accessed Secured Finance.

The next two chapters explore the potential benefits, risks and costs associated with DC pension scheme investment in Secured Finance.

Conclusions

- The profile of DC savers has changed, post automatic enrolment, to include many people with lower levels of financial capability, who are likely to save over longer time horizons and are more likely to be in the default fund.
- These new DC savers are less likely to have the capability and pot sizes to take risky investment decisions, such as investment into alternative (illiquid and privately listed assets), on their own.
- However, members of DC schemes could benefit from investment in alternative assets, if the potential benefits and risks are taken into account on their behalf, by their provider.
- One of these assets, Secured Finance, could provide increased diversification and higher returns.
- Secured Finance investment products provide elements of structural protection which help mitigate risk, including collateral backing, though these added layers of protection increase the costs of investing in these assets.
- Investment into Secured Finance is becoming more popular with DB schemes and other institutional investors but has not yet been widely accessed by UK DC schemes.

16 AXA IM (2019)
17 Thompson & Fevzi (ICLG) (2019)
18 Investment Association data
19 National Australia Bank (2019)
20 Ignites Asia (2009)

Chapter Two: What are the potential benefits of DC investment into Secured Finance?

Chapter Two sets out the characteristics of DC schemes which could benefit from investment in Secured Finance and explores the potential for these investments to yield higher returns and portfolio diversification

Larger, cash-positive Defined Contribution (DC) schemes are more likely to be able to bear the increased risks and costs associated with investment in Secured Finance and could access a higher return and increased portfolio diversification as a result of investment into these assets.

Larger, cash positive DC schemes, such as master trusts, are more likely to be able to afford to invest in Secured Finance, and will generally be more able to bear the attached risks and uncertainties

Secured Finance, as with most alternative assets, costs more to invest in. The purchase and holding costs of Secured Finance are higher than those for publicly listed assets, for the following reasons:

- Transaction costs are higher because there are extra costs and charges involved in buying and selling these types of assets such as legal costs associated with reviewing the underlying contracts and the costs of valuation.
- Investment into private credit often requires a large outlay of initial capital as a minimum proportion of the loan amount will be required from each investor. These large initial investments may not be affordable for smaller pension schemes.[21]
- Illiquid investments are complex and information, including pricing information, may not be as readily available or transparent as for listed assets which are on public exchanges and traded in high volume, much of which is automated. Investment managers must do due diligence, as well as valuing and monitoring these assets, which will generally result in higher management fees.[22]

Added layers of complexity and cost mean that either the investor themselves (in this case the Trustee or provider) or the platform manager will need to expend more resources and funds on managing a Secured Finance investment than they would on a fund invested in publicly listed assets. The added resource required for investment means that the fees charged by fund managers, which are eventually passed on to members, are higher than for publicly listed investments.

21 GAD (2016); EYGM (2015)
22 ROBECO (2015)

Larger schemes are more likely to be able to bear high up-front and ongoing costs

The overall hoped-for return generated from Secured Finance could, over time, make up for higher costs. Larger, cash-positive schemes, such as large master trusts, are more likely to be in a position to afford upfront and ongoing costs and to lock away a proportion of funds in anticipation of a potentially increased future return. However, smaller pension schemes may not have a sufficient investment budget to cover initially high, or ongoing, investment costs.

Larger, cash-positive schemes, such as large master trusts, are more likely to be in a position to afford upfront and ongoing costs and to lock away a proportion of funds in anticipation of a potentially increased future return.

Consolidation, scheme closures and fund pooling could increase the proportion of DC schemes which can afford to invest in Secured Finance

Current moves by Government to encourage consolidation or closure (for example, the authorisation regime for master trust schemes and the proposal for small trust-based DC schemes [potentially those with fewer than 1,000 members] to regularly assess whether their members would be better off if they were put into another scheme)[23] should mean that fewer schemes in future will be too small to afford investment into Secured Finance.

Pooled funds allow smaller schemes to share costs and access more expensive assets

Smaller schemes can pool capital or invest in pooled funds to access assets which require high initial investment capital, and which may generally be more expensive to invest in individually, as a result of higher charges.[24] An increase in the development of pre-made pooled fund products will make access to these types of assets easier for small DC schemes, as costs and initial investment amounts can be shared. Pooled investments may become problematic if one scheme needs to withdraw funds early, though special provisions can be built into funds to mitigate the effect of early withdrawal.

Schemes contemplating investment into Secured Finance will need to consider the potential for returns and diversification against the increased costs. The next chapter explores the risks associated with DC scheme investment into Secured Finance.

In some cases, Secured Finance could deliver an increased return, over publicly traded debt assets (such as bonds and gilts)

Secured Finance investments are intended to generate an extra premium, in return for the illiquidity and the complexity associated with investment in these products.

- An illiquidity premium is the estimated increase in return associated with investments in which capital is locked away for a period of time.
- A complexity premium refers to the increase in return an investor expects for the higher than average levels of complexity associated with managing particular asset types.

The net amount of extra return will vary, and is not necessarily predictable

Estimates of the total amount of extra return that could be realised from investment in Secured Finance range between 2% to 6% above comparably rated credit.[25] It is difficult to precisely estimate the full net return from investment in Secured Finance because:

- There is little consensus regarding the amount of extra return associated with these assets; most current estimates are produced by asset managers and a wider range of sources of estimates by independent will be needed in order to draw firm conclusions,
- Some of the extra return may be eroded by costs associated with these assets,
- There are risks associated with investing in privately listed assets, including Secured Finance, which, if realised, could reduce returns, though there are also risks associated with investing in publicly listed assets.

23 DWP (2019)
24 Wilkinson, L. (PPI) (2017)
25 www.insightinvestment.com/uk/consultants/investment-range/fixed-income/secured-finance/what-drives-returns-in-secured-finance/; Investment Insight (2017); Mercer (2017)

As there isn't conclusive evidence regarding the full gross return from investment in Secured Finance, and there are many different factors which can affect returns, it is worth further exploration by independent bodies of the extent to which Secured Finance can provide increased returns over similar, publicly listed assets, after accounting for increased costs and risks.

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There is potential for Secured Finance to provide diversification, though it is hard to compare directly with other asset classes

Secured Finance assets are not always correlated to the stock as their value will fluctuate as a result of different market forces than publicly listed assets.[26]

Low correlation can assist an investment portfolio by maintaining value in some assets when other assets suffer from loss, thereby providing downside protection, and can also diversify portfolios by exposing them to the opportunity for higher returns in less well explored areas of the market.

Correlation: how closely asset types change in value in relation to other asset types.

Downside protection: techniques which protect against losses to some or all of the investment portfolio.

Secured Finance assets often originate from bank and insurer loans which investors may not otherwise have access to. These types of investments can provide exposure to a diverse range of illiquid assets within the economy, for example, property development, corporate mortgages, infrastructure and company loans.

It is not easy to identify true diversification

While low correlation is likely to result from a number of factors. Some of the lack of correlation is likely to be due to uncertainties in the value of less liquid assets, as a result of the much lower frequency of market pricing information. Unlike publicly traded equities, illiquid assets are not generally given a daily valuation, and investors may be provided with a full appraisal on a quarterly basis or even less frequently. More frequent price valuations on illiquid assets may be estimates based on previous and expected future valuations and may appear smoother than they would if new market-tested valuations were undertaken on a daily basis.

Due to the complexities of evaluating illiquid assets, and the lower levels of transparency, it may be difficult to correctly value the underlying collateral in Secured Finance loans. The difficulty of valuation can be exacerbated during times of great market turbulence, when a value taken for example, quarterly, could greatly under or overestimate the true value of the asset.

There is scope for further investigation by independent bodies of the true diversifying potential of Secured Finance.

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Diversification can be accomplished in many other ways, for example, investing in different asset types in different countries. Those using private credit to diversify may wish to include it in a portfolio with other assets, rather than using it as a sole diversification tool.

Conclusions

- Larger, cash positive DC schemes, such as master trusts, are more likely to be able to afford to invest in Secured Finance and will generally be more able to bear the attached risks and uncertainties.

26 Aon Hewitt (2014)

- Secured Finance investments are intended to generate an extra premium, in return for the illiquidity and the complexity associated with these products. However, it is difficult to precisely estimate the full gross return from investment in Secured Finance.
- As there isn't conclusive evidence regarding the full gross return from investment in Secured Finance, and there are many different factors which can affect returns, it is worth further exploration of the extent to which Secured Finance can provide increased returns over similar, publicly listed assets, after accounting for increased costs and risks.
- Secured Finance assets are not always correlated to the stock market because they are not generally subject to the same accounting standards, volatility, or costs of listing as public assets. Diversification and low correlation can assist an investment portfolio in maintaining value in some assets when other assets suffer from loss and can also expose portfolios to the opportunity for higher returns in less well explored areas of the market.
- Some of the lack of correlation is likely to be due to uncertainties in the value of less liquid assets, as a result of the much lower frequency of market pricing information.
- There is scope for further investigation of the true diversifying potential of Secured Finance.

Chapter Three: What are the potential risks associated with DC scheme investment in Secured Finance?

Chapter Three considers the risks associated with DC pension scheme investment in Secured Finance.

While there are potential benefits associated with Defined Contribution (DC) scheme investment into Secured Finance, there are also potential risks attached. The main risks which schemes need to consider when looking at this type of investment are

- Illiquidity risk,
- Interest rate risk,
- Default risk, and
- Reputational risk.

Schemes looking at investment into Secured Finance will need to consider the trade-offs between these risks and the potential benefits. In particular, schemes will need to consider whether their members, and the scheme funding position, can bear these risks, and how to structure their investments in order to ensure that the realisation of risks will not result in irrecoverable loss.

This chapter considers each of these risks in turn.

Illiquidity risk: there are risks attached to locking a portion of capital away

Secured Finance investments are generally "locked away" for a period after the initial investment, during which time funds cannot be accessed, or can only be accessed through application or a long period of notice.[27] Illiquidity is particularly high for long-term building related loans such as property development and infrastructure. Restricted access to funds could cause cash-flow problems for DC pension schemes if they have unexpected costs, high levels of transfers out, or if other investments perform poorly and their liquid capital is reduced.

DC schemes, particularly smaller ones, will require a certain amount of liquid capital to be available at all times, in order to maintain ongoing administration expenses, people switching between funds and transfer costs which can be unpredictable after the point at which people reach age 55 (as behaviour may change as a result of market changes, regulation

27 Mercer (2017)

and economic effects). As schemes grow in value, and the average pot size increases, there may be higher proportions of funds available for investment in illiquid assets after accounting for those required for cash-flow management. Larger, cash-positive schemes, such as large master trusts will generally find it easier to manage a certain portion of illiquidity in their investments.

There are methods for calculating the proportion of funds a scheme might safely be able to invest in illiquids, for example, one asset allocation model suggests that 4.8% of pension schemes' assets under management should be a safe amount to invest into an illiquid asset which cannot be accessed for ten years.[28] However, in order to avoid needing to gain early access to an illiquid asset, potentially through selling the asset on at a lower than market price, individual schemes need to carefully calculate and keep under review the proportion of liquid funds they would require in the case of a market downturn.

In order to avoid needing to gain early access to an illiquid asset, potentially through selling the asset on at a lower than market price, individual schemes need to carefully calculate and keep under review the proportion of liquid funds they would require in the case of a market downturn.

There is a risk that fund managers may gate funds in times of significant fund loss

Illiquid funds have come under scrutiny recently, with the suspension of withdrawals ("gating") from seven UK property funds, which were unable to meet investor demands after the Brexit vote in 2016.[29] In 2019, the Woodford Equity Income Fund, (a fund containing illiquid investments, which had also suffered losses after the Brexit vote) was unable to cope with the proportion of investors wanting to withdraw funds and gated funds despite investor demands.[30] Gating is frustrating for investors as they cannot prevent investments being subjected to further losses before funds are made available. The fund manager, on the other hand, will generally feel that they need to gate in extreme circumstances, in order to prevent more losses arising from having to sell illiquid assets on the secondary market before their contract has reached full maturity.

As a result of these recent events, both scheme members and schemes might be more wary of investing in illiquids. The potential for fund managers to gate illiquid funds is an additional risk that schemes will need to take into account when weighing up the potential benefits and risks of investing. Larger, cash-positive schemes will find these risks easier to manage.

The potential for fund managers to gate illiquid funds is an additional risk that schemes will need to take into account when weighing up the potential benefits and risks of investing.

Interest rate risk: income may not always rise with inflation

The main market-risk affecting fixed-income products such as bonds and private credit, including Secured Finance, is that returns do not keep track with rises in interest rates. Returns below interest rate rises can create difficulties with scheme cash-flow management and are likely to represent a loss in the value of funds which are expected to rise with interest rates or above. However, the majority of Secured Finance investments provide a floating interest rate[31] which varies with Bank of England central rates. While a floating rate provides access to the benefits of interest rate rises, it will also result in a reduced rate when interest rates falls.

28 Robeco (2015) p. 13, table 3; figures derived from "*an asset allocation model which takes illiquidity into account. Their main results are based on a scenario where an investor consumes a certain amount of their wealth in each period. The universe consists of three assets: a risk-free bond, a liquid and an illiquid risky asset. They analyse how much should be invested in the illiquid risky asset according to the different levels of illiquidity of this asset. The remaining, liquid wealth is allocated to the risk-free bond and the liquid risky asset. The investor consumes out of this liquid wealth. The analysis is performed for an investor with average risk aversion.*"

29 Financial Times (2019)

30 BBC News (2019)

31 AXA IM (2019)

A floating rate will generally keep pace with interest rate rises, however they may not always account for other changes in the value of goods and services taking place in the economy, such as rises in property prices, (though this is also true for other fixed-income products). Schemes will need to ensure that they are not depending on Secured Finance investments to protect all of their inflation needs, while recognising that income from Secured Finance will generally rise with interest rates.

Schemes will need to ensure that they are not depending on Secured Finance investments to protect all of their inflation needs, while recognising that income from Secured Finance will generally rise with interest rates.

Default risk: defaults on loans could result in a loss despite collateral backing

Those investing in Secured Finance are exposed to some default risk even though these assets are backed by collateral. If the original debtor defaults, claiming back assets may be a costly and complex administrative process and lenders may not always receive back the full value of the investment. This can result in a loss of funds for schemes and members.

Default risk is affected by changes in the wider economy, such as the COVID-19 pandemic, which could lead to recessions, affect company earnings and reduce their ability to make interest and capital payments on debt. Micro market changes that affect the individual performance of a company, such as increases in competition, could also affect a company's ability to repay debts. Individual loans will also be affected by both wider economic changes and changes to individual circumstances such as job loss.

DC schemes investing in Secured Finance will need to carefully evaluate the financial health of underlying companies and organisations, or have their asset manager do so on their behalf, in order to ensure that they are not taking undue risk with member's contributions.

DC schemes investing in Secured Finance will need to carefully evaluate the financial health of underlying companies and organisations in order to ensure that they are not taking undue risk with member's contributions.

Reputational risk: Secured Finance investments may carry reputational risks as a result of the 2007-2010 sub-prime mortgage crisis

Sub-prime mortgages and Collateralised debt obligations, which lay at the foundation of the 2008 financial crisis are structured in a similar way to Secured Finance investments as they are both collections of underlying loans. However, since 2008, regulation around investments into loans has been tightened. Regulation at the EU level, which impacts the UK, has increased the obligation on banks and asset managers to monitor and report on the quality of underlying loan assets and maintain sufficient liquid capital to prevent significant loss to investors during times of economic stress. Similar legislation has also taken place in the US.[32] For example, some of the following changes have been made since 2008:

- Pension funds are required to understand the underlying risks and structures of securitised investments and to obtain required information from the original parties.[33]
- Original loan parties are required to provide sufficient information for stress tests to be conducted on cash-flow and underlying collateral values.[34]

32 AXA IM (2018)
33 AXA IM (2018)
34 AXA IM (2018)

- Loan issuers are required to obtain at least two credit ratings, with at least one originating from an agency with 10% or less interest in the relevant securities, in order to avoid conflicts of interest.[35]
- Original issuers are required, on an ongoing basis, to retain, at minimum, a 5% proportion of exposure to the loan, therefore ensuring issuers are motivated to ensure retention of quality.[36]

Despite increases in regulation, members may be wary of schemes investing their contributions into Secured Finance. If companies or individuals' default on underlying loans, leading to fund losses, schemes may come under scrutiny for not learning lessons from the sub-prime crisis. Schemes will therefore need to be particularly careful when considering the underlying default risk of Secured Finance investments, as loss to fund value may also result in reputational damage.

Schemes will need to be particularly careful when considering the underlying default risk of Secured Finance investments, as loss to fund value may also result in reputational damage.

Conclusions

- In order to avoid needing to gain early access to an illiquid asset, potentially through selling the asset on at a lower than market price, schemes need to carefully calculate and keep under review the proportion of liquid funds they would require in the case of a market downturn.
- The potential for fund managers to gate illiquid funds is an additional risk that schemes will need to take into account when weighing up the potential benefits and risks of investing.
- Schemes will need to ensure that they are not depending on Secured Finance investments to protect all of their inflation needs, while recognising that income from Secured Finance will generally rise with interest rates.
- Schemes investing in Secured Finance will need to carefully evaluate the financial health of underlying companies and organisations in order to ensure that they are not taking undue risk with member's contributions.
- Schemes will need to be particularly careful when considering the underlying default risk of Secured Finance investments, as loss to fund value may also result in reputational damage.

35 AXA IM (2018)
36 AXA IM (2018)

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