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Government to accelerate UK pension 'megafunds' creation

Promise of unlocked investment could have profound implications for real estate

Chancellor of the Exchequer, Rachel Reeves, poses with the red Budget Box as she leaves 11 Downing Street to present the government's annual budget to Parliament on October 30, 2024 in London. (Photo by Leon Neal/Getty Images)

By Paul Norman
CoStar News

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The government plans to speed up the drive to merge the UK's 86 council pension schemes into a handful of pooled "pension megafunds", as well as to push for private sector workers' defined-contribution pension schemes to be pooled into bigger funds.

The moves, if successful, promise to have a profound impact on real estate investment in the UK.

The government on Thursday pledged the pension megafunds will be created as part of the "biggest set of pension reforms in decades, unlocking billions of pounds of investment in exciting new businesses and infrastructure and local projects".

It added that Chancellor Rachel Reeves will use her first Mansion House speech to the City on Thursday evening to outline the plans.

The reforms will be introduced through a new Pension Schemes Bill next year and will create "megafunds through consolidating defined contribution schemes and pooling assets from the 86 separate Local Government Pension Scheme authorities".

A process began in 2015 to pool the 86 authority pension schemes into eight funds, but progress has been slow as it takes time to create the low costs and scale required.

The government said the megafunds will mirror the situation in Australia and Canada, where pension funds take advantage of size to invest in assets that have higher growth potential. It said the move could deliver around £80 billion of investment in "exciting new businesses and critical infrastructure while boosting defined contribution savers’ pension pots".

John Forbes, of John Forbes Consulting, an expert on the pension system, tax and real estate, responded to the announcements by saying: "“It is not a doctrinal change from the reforms initiated by the previous regime, but a call for more vigorous flogging of the recalcitrants."

The government launched its review of the pensions system in August while the Chancellor also met the "Maple 8" group of Canadian pension funds as she urged UK schemes to consider their approach.

Canada’s top schemes, known as the Maple 8, include Ontario Teachers' Pension Plan and Canada Pension Plan Investment Board and collectively manage around £1.1 trillion worth of taxpayer-backed pension schemes for public sector workers. They have invested billions in the UK, including in major real estate and infrastructure, such as stakes in Associated British Ports, Westfield Stratford shopping centre, and the redevelopment of the BBC Television Centre in west London.

The government's analysis, published in the interim report of the Pensions Investment Review at Mansion House – shows that pension funds begin to return much greater productive investment levels once the size of assets they manage reaches between £25 billion-£50 billion.

It said the Local Government Pension Scheme megafunds will be run by professional fund managers and will need to to be authorised by the Financial Conduct Authority. Governance of the LGPS will also be "overhauled to deliver better value from investment decisions".

Under the plans each administering authority will be required to specify a target for the pool's investment in their local economy, working in partnership with local and mayoral combined authorities to identify the best opportunities to support local growth. A new independent review process will be established to ensure each of the 86 administering authorities is fit for purpose.

The analysis also finds that defined contribution pension schemes are set to manage £800 billion worth of assets by the end of the decade. There are around 60 different multi-employer schemes, each investing savers' money into one or more funds. The government will consult on setting a minimum size requirement for these funds to "ensure they deliver on their investment potential".

The government will also consult on measures to facilitate consolidation of these private sector workplace schemes into megafunds. Reeves, speaking to the Financial, said she is targeting a minimum size for multi-employer defined contribution pension schemes of £25 billion to £50 billion to "facilitate their consolidation into megafunds". The government will look at legislating to allow fund managers to more easily move savers from underperforming schemes to ones that deliver higher returns for them.

In a DC scheme, a fund of money is built up from the individual's contributions, those an employer makes and tax relief from the government. Employees can choose their own funds and switch between them. Managers therefore often offer only liquid investments that can be traded daily, which creates a problem for an illiquid asset class like real estate. The market is also highly fragmented with a large number of very small schemes.

Also, the Pension Policy Institute estimates that 96% of DC members are investing in the default option which often does not include a real estate fund. Research from Columbia Threadneedle finds that, on average, 20 years before retirement only 0.7% of a DC portfolio is invested in real estate.

John Forbes, of John Forbes Consulting, an expert on the pension system, tax and real estate, has pointed out that this can be inefficient and limits the ability to invest in illiquid assets. "The previous government saw this [consolidation] being achieved through the master trusts."

Forbes said "Collective DC" is an important initiative. Collective defined contribution pension schemes are an innovation in the UK pensions market where contributions are collected akin to a DC scheme, but pooled and invested with a view to delivering a sustainable target benefit level, more like defined benefit pension schemes.

He added the process of tackling the fragmentation of the Local Government Pension Scheme is "quite hard when you dig into the detail", which is why it has taken quite a while to consolidate the 86 schemes into eight pools.

Local authority schemes were amalgamated into the pools, starting in 2015, to reduce costs and target infrastructure investment, among other priorities. In 2022, government set out targets for LGPS pensions to invest at least 5% of their assets in projects that support local areas, potentially unlocking £16 billion of capital.

"I think that there are pros and cons to pooling further," Forbes said. Governments have, for instance suggested the eight current pools should be merged into a single behemoth.

"To me, it makes more sense to encourage the completion of pooling in the existing eight pools," said Forbes. "I think that this is a very different situation to the DC schemes."

In terms of the government's review being used to encourage greater investment in UK assets, Forbes has previously said, although superficially tempting, this needs to be treated with care.

"Schemes have a fiduciary duty to do what is in the interest of policy-holders rather than funding pork-barrelism. However, removing obstacles to investment in illiquid assets can

achieve both."

Ahead of the government's announcement Abrdn pointed out that in the Mansion House Compact of 2023 major pension funds agreed to invest more in unlisted assets, but the focus has primarily been on private equity and venture capital. The fund manager has called for this to be extended to other private assets such as real estate, infrastructure and private debt as well as UK listed smaller companies because of the growth potential they offer.

It conducted a survey that found that more than half (54%) of people would like their pension to have a greater allocation to private assets, such as housing schemes, infrastructure projects and early-stage growth companies. Only 14% said they would not want this, while 32% were not sure.

Similarly, the majority (57%) of people would like their pension to include a higher percentage of UK company shares. However, for 42% of people, that was on the proviso that investing more in the UK does not impact returns.

Tom Frost, head of UK institutional clients at Abrdn, said: "We believe some level of consolidation of corporate defined benefit pension schemes would support greater investment into […] productive growth areas. There is a very long tail of small schemes that have neither the scale nor the expertise to make investment decisions on anything but the most 'vanilla' of assets. Consequently, consolidation is necessary to enable schemes to grow to a scale which enables investment in a wider range of assets with a greater appetite for rewarded risk.

"However, there are risks which could arise in an over-consolidated market. If the number of schemes is reduced to too low a number, this could limit innovation and lead to decreased competition, thereby resulting in poorer outcomes for current and future pensioners. It could also limit the government's ability to identify good practice and encourage its adoption elsewhere."

Andrew Groves, Head of Capital Markets at Bidwells, said: "Encouraging pension funds to consolidate is a clear signal that this government is taking domestic investment seriously. I'd still caution that scale doesn't necessarily mean that these institutions will invest in

UK assets that are perceived as needing a greater risk tolerance, on the basic principle that horses can be drawn to water but won't be forced to drink. Especially in the case of UK infrastructure, for very obvious reasons."

Real estate investors are still awaiting an agreed solution to the liquidity mismatch for funds for retail investors that invest in daily-traded authorised property funds.

The Financial Conduct Authority has been investigating the issue since March 2017 and an answer has been promised later this year. It previously suggested funds should be required to have notice periods before an investment can be redeemed and consulted on a notice period of between 90 and 180 days.

Forbes said: "We believe that the answer that they are still inclined towards is fixed notice periods as introduced for the Long Term Asset Funds. We do not believe that this is the right answer, although it might be in some circumstances.

"There is an issue for Individual Savings Account eligibility if mandatory notice periods are introduced."

In a statement about the government's pension reform plans the Chancellor of the Exchequer said: "Last month's Budget fixed the foundations to restore economic stability and put our public services on a firmer footing. Now we're going for growth That starts with the biggest set of reforms to the pensions market in decades to unlock tens of billions of pounds of investment in business and infrastructure, boost people's savings in retirement and drive economic growth so we can make every part of Britain better off."

Pensions Minister Emma Reynolds said: "Harnessing the power of this multi-billion-pound industry is a win-win, benefiting future pensioners, and our wider economy. These reforms could unlock £80 billion of investment into exciting new businesses and critical infrastructure."

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