Challenging times for UK institutional capital

THE FUND MANAGER

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Even before the change of government in July, UK institutional capital had been undergoing a period of dramatic change.

Regulatory, demographic and other pressures were having a huge impact on pension schemes and life insurers, which in turn was having a significant effect on investment in real estate as an asset class. The incoming Labour government arrived with a clear manifesto commitment to further institutional reform, a key component of which is increasing investment in illiquid assets.

What does this change mean for the UK capital universe, and what impact will this have on investment in real estate as an asset class?

The defined benefit to defined contribution pension transition

UK corporate defined benefit pension provision has been waning for decades. The long-term decline was accelerated by the Liz Truss mini-budget in September 2022, when the Prime Minister and the Chancellor of the Exchequer lobbed in a hand grenade triggering a Liability-Driven Investment (LDI) liquidity crunch.

DB schemes are de-risking, heading into run-off and transferring liabilities into the insurance bulk annuity market. This has a number of important impacts:

- DB pension investment has historically been a mainstay of UK institutional real estate investment. Many

schemes are now selling their direct real estate and interests in funds. Open-ended funds with a large exposure to corporate DB schemes have seen very significant redemptions and UK corporate DB schemes can be pretty much ruled out as a source of capital for new real estate investment.

- Not all DB schemes are heading straight for the exit. What happens to current surpluses in DB schemes that may continue? This was covered in a Department of Work and Pensions (DWP) consultation that closed in April. The outcome of this consultation is awaited and will no doubt be picked up in the new government's broader pension review.
- When schemes transfer assets and liabilities into the insurance bulk annuity market, some of the investment may be in real estate, but for regulatory reasons, there are significant differences to investment by the DB schemes themselves. Insurers benefit from a much better capital requirement treatment if they use investments that fall within the Solvency II Matching Adjustment (MA) rules to match the liabilities that they have been acquiring.

As DB declines, it is being replaced by defined contribution (DC) pension provision. Although it had taken them over a decade to get there, the previous government had finally made progress before departure in creating a new legislative framework for DC pension investment that should improve outcomes for policyholders and facilitate deployment of capital into illiquid assets including real estate. Three aspects are key:

- Consolidation of smaller schemes.
- The introduction of a "Value for Money" framework to focus more on policyholder outcomes and less on simply controlling the level of management fees. Historically DC schemes have been beset by knowing, in the words of Oscar Wilde, "the price of everything and the value of nothing".
- The introduction of the Long-Term Asset Fund (LTAF), which has been introduced specifically to facilitate investment by DC default funds in illiquid assets. We had, and still have, deep reservations about fixed notice periods as a feature of the LTAF and there are significant operational problems for LTAFs and other funds with notice periods being accessed through investment platforms. The first few LTAFs have been launched, but at this point, take up is very limited.

In a briefing document alongside the King's Speech, the government provided details of a forthcoming Pension Schemes Bill. The detail published largely replicated what has been done already, but the government is also moving forward with its manifesto commitment to a broader pensions review.

On 16 August, the government published a brief terms of reference for the review to be led by the DWP. Further clarity should therefore be available over the Autumn. Sorting out the operational challenges that impede investment in real estate and infrastructure has to be the highest priority.

The Local Government Pension Scheme

The Local Government Pension Scheme (LGPS) is the pension scheme for local government employees, plus some other organisations that have joined the scheme. It is administered by 86 local pension funds and has historically been a major investor in direct real estate and funds.

A process started in 2015 to push the LGPS into a much smaller number of investment pools. After much dancing around handbags, the 86 schemes coalesced into 8 pools. However, the actual process of asset pooling has been slower than many in the previous and current governments had anticipated.

Efforts to accelerate this were already underway prior to the general election. The new government has already made it very clear that it wants to take this further. The Chancellor of the Exchequer has publicly expressed her interest in the Canadian public pension model and in August met in Toronto with the "Maple 8", the largest Canadian public pension funds. These typically have much higher allocations to illiquid assets than the UK LGPS.

The terms of reference mentioned above for the pensions review specifically mentions "tackling fragmentation and inefficiency in the Local Government Pension Scheme through consolidation and improved governance."

National Wealth Fund

The establishment of a National Wealth Fund had already been announced prior to King's Speech.

Investment will be through the existing UK Infrastructure Bank, chaired by Chris Grigg, the former CEO of British Land. Through the infrastructure bank, £7.3 billion is being earmarked to be allocated for investment. This is intended to unlock private sector investment and the government's announcement included supportive comments from several institutions.

The National Wealth Fund will be put on a permanent statutory footing via a National Wealth Fund Bill.

The primary focus will be investment in decarbonisation. We will all need to await further details and the bill to see how much of this, if any, ends up in real estate as an asset class.

So what does this all mean?

Traditional UK institutional capital is in a state of flux. A chronic ailment was turned into an acute attack following Liz Truss' mini-budget. How this ultimately plays out will be crucial for long-term real estate investment. The new government is keen to take a lead in shaping this, and clearly wants to move quickly. All eyes should therefore be on the looming DWP pension review.

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