PENSIONS POLICY INSTITUTE

PPI

Pension scheme assets – a deep dive into infrastructure

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Pension scheme assets deep dive series #2

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We believe that better information and understanding will lead to better policy framework and better provision of retirement for all

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This second deep dive, kindly sponsored by the **Association of British Insurers (ABI)** is part of the PPI's broader pension scheme asset strands study and explores how patterns in investment into alternatives have changed in the past, where investment is today, and how it might change in future, and asks what all this means for schemes and members.

Funding has been given to help fund the research and does not necessarily imply agreement with, or support for the analysis or findings from the project. The PPI does not make recommendations as to the appropriate direction of future policy, Instead, our work provides **INDEPENDENT** evidence to allow policy development to be well informed.

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Prev Next

Executive Summary

Pension scheme investment in infrastructure is receiving increased focus. Investment in infrastructure, at least as a specifically identified asset, is a recent trend and has been developing notably over the last 5 years. The picture of how pension assets are invested is patchy and inconsistent but the evidence suggests that at present infrastructure assets form a small minority of current asset allocations at around 1-3% of pension scheme assets under management. The investment fundamentals of infrastructure, the opportunities to diversify asset holdings through infrastructure, and the resultant contribution to wider environmental and social investment goals suggest that investment in infrastructure is set to grow strongly over the medium term.

This Deep Dive, the third output in the Asset Strand Series, presents an in-depth overview of the issues relating to pension schemes' investment in infrastructure in 2024.

This Deep Dive explores:

- What we know, and don't know, about current levels of infrastructure investment
- What makes infrastructure investments attractive to schemes
- How infrastructure investment is helping schemes manage volatility
- The potential impact of policy and regulatory changes
- Barriers to increased scheme investment

The key findings can be summarised as follows:

- Investment in infrastructure is set to increase as pension schemes mature and investment capabilities increase
- Infrastructure is expected to form a significant core holding for specialist buy-out insurers
- Large open Defined Benefit (DB) schemes are also investing to increase diversity and resilience of investment returns
- Defined Contribution (DC) schemes need to develop scale and specialist management capabilities to make infrastructure an attractive and cost-effective component of their asset mix
- Better processes and mechanisms to define and collect consistent data would aid better analysis of developments within and across schemes

Current investment in infrastructure

It is only within the last few decades that institutional investors have begun viewing infrastructure as a distinct asset class, rather than an element of other investments (such as listed companies or fixed income funds). The benefit of infrastructure as an asset that can allow for volatility management and liability driven investment has meant that it has become of greater interest to pension schemes.

While Defined Benefit (DB) schemes have recognised the benefits of infrastructure investment for a while, in the past few years, Defined Contribution (DC) schemes are starting to explore this type of investment more. DC interest in infrastructure has been strengthened as economic crisis have increased the value of assets which help volatility management. Calls for greater consideration of Environmental, Social and Governance (ESG) factors have also generated more interest in investment into transitional infrastructure projects. A UK Government focus on Value for Money alongside encouragement of greater investment in illiquids and UK projects, and increases in scheme scale, are likely to increase interest in this area from DC schemes.

Information on pension schemes' allocation to infrastructure is patchy but the data that is available suggests allocations are relatively low

It is challenging to identify precisely how much UK pension schemes allocate to infrastructure at present, partly because of the way that asset allocation data is collected and defined. Infrastructure is often grouped together with other asset classes, such as private equity, private debt and commodities, in the 'alternatives' or 'other' category, making it difficult to identify how much is allocated to infrastructure specifically.

The methods through which schemes invest in infrastructure can also make it challenging to identify the level of allocation as schemes may invest through multi-asset funds that include infrastructure, rather than directly, and may not report the underlying asset mix of these funds in data collections; they may also invest via credit or debt assets, without reporting the allocation as infrastructure.

PPI survey data is designed to disaggregate infrastructure from other asset classes as much as possible. According to the 2023 DC Asset Allocation Survey, DC schemes allocate between <1% and 3% to infrastructure, depending on the stage in the saving journey. The first-time infrastructure was included as a separate category rather than bundled into the 'other' category in the DC Asset Allocation Survey was 2018. The data for that year illustrates little change compared to the 2023 data with allocation at 3% or less throughout across all scheme types.[1]

Data on DB scheme allocation to infrastructure is even more challenging to find, as the main source of aggregated information on DB asset allocation, the Pension Protection Fund (PPF) Purple Book, includes infrastructure within the 'other' category. However, there is some evidence of increased appetite for infrastructure assets among DB schemes in recent years. For example, Local Government Pension Scheme (LGPS) funds have continued to see positive flows into infrastructure, particularly going into green or renewable investments. Infrastructure represented 6% of LGPS assets in England and Wales in 2023.[2]

Allocation to infrastructure is expected to increase as investors respond to changes in the economy and across society more broadly

Infrastructure is expected to be the second-fastest growing form of private-capital assets under management, with an expected compound annual growth rate of 13.3% until 2027.[3] There is widespread recognition of the potential benefits of investing in infrastructure (Figure 1).

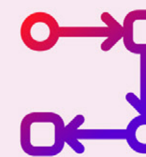
[1] PPI DC Asset Allocation Survey 2023
[2] LGPS Advisory Board Annual Report 2023 (2024) at https://lgpsboard.org/index.php/scheme-annual-report-2023
[3] Preqin (2023); Abrdn (2023) Infrastructure: How sustainability is focus of new investments

Figure 1: Potential benefits of investing in infrastructure

Long investment horizon suited to pension objectives

Expected to perform well in volatile and high-inflation economic scenarios

Illiquidity premium: higher expected returns in return for less frequent trading



Can provide predictable, structured returns over the long-term

The key areas of focus for infrastructure investment have shifted with the economy and society in recent years

As the economy (both global and UK) and society more broadly have gone through significant shifts in recent years, so too have the key areas of focus for infrastructure investment:

- **Renewable energy:** There's a growing focus on investing in renewable energy infrastructure, such as solar, wind and hydroelectric power projects (sustainability and ESG considerations are discussed in more detail later in this Deep Dive).[4] Ongoing geopolitical tensions and increased digitisation have reinforced the importance of energy security more broadly.[5]
- **Digital infrastructure:** The rapid digitisation of economies worldwide has led to increased investment in digital infrastructure, including 5G infrastructure and fibre optic networks.[6] As demand for connectivity and data storage continues to grow, accelerated by changes in working patterns resulting from the pandemic, so does the investment opportunity for these kinds of infrastructure projects.[7] Digital infrastructure also has a role to play in the transition to net zero.[8]

[4] GLIL (2021) Infrastructure Annual Review 2021
[5] Mercer (2023) Themes and opportunities 2024: An age of agility
[6] Schroders (2020) Why digital infrastructure could emerge stronger from Covid-19; Oughton, Amaglobeli & Moszoro [IMF] (2023) Estimating digital infrastructure investment needs to achieve universal broadband
[7] Jaumotte et al. [IMF] (2023) How pandemic accelerated digital transformation in advanced economies; Meyers [Centre for European Reform] (2024) Helping Europe's digital economy take off: An agenda for the next commission; FCDO (2024) Digital development strategy 2024 to 2030
[8] Actis (2022) Global digital infrastructure investment: Enabling a just transition

- **Transport:** Investments in transportation infrastructure remain attractive, particularly in sectors such as airports, seaports and toll roads. As urbanisation increases, particularly in developing and high-growth countries, new transport infrastructure is needed to support population shifts from the countryside to cities.[9] However, there is also a growing focus on sustainable transportation solutions, such as electric vehicle charging networks and public transport systems.[10]
- **Social infrastructure:** Investments in social infrastructure, including healthcare facilities, schools and affordable housing, are gaining attention due to their potential to deliver both financial returns and social impact.[11]
- **Emerging markets:** Driven by rapid urbanisation, population growth and the need for improved infrastructure to support economic development, emerging markets present different opportunities for investment in infrastructure. Because many emerging markets are in the early stages of their development, they can have better long-term growth prospects relative to more mature developed markets, as well as diversification benefits.[12] However, they can also come with unique challenges, such as political instability, regulatory risks and currency fluctuations.[13]

Infrastructure can be particularly appealing in times of economic volatility and uncertainty

There has been increased appetite for and consideration of infrastructure in recent years due to returns being resilient to market cycles and economic stress. It's generally been the expectation that infrastructure will perform well in low-growth, high inflation environments, providing more stable returns in inflationary environments compared to other asset classes. A significant proportion of infrastructure assets include explicit inflation protection, while others without an explicit link may offer some implicit protection. The monopolistic position of many infrastructure projects and the essential nature of the assets and services they provide can also ensure stable returns in times of volatility and uncertainty. While this resilience to volatility and inflation has long been recognised as a potential benefit of allocating to infrastructure, it has become much more of a reality in recent years.

Appreciating the nuances of specific investments is important when assessing their resilience to major economic or social change

So, infrastructure can give funds a greater ability to weather market volatility. But when there are dramatic shifts, whether economic or social and with longer-term implications, infrastructure is unlikely to be immune. Understanding the adjusted levels of risk and return will be increasingly dependent on investors' ability to appreciate the nuances of specific infrastructure investment opportunities. It is expected that there will be a growing divergence in performance between investments which have secured inflation-linked returns at low-interest costs, and those that have not.

Sharp increases in short-term interest rates seen in recent years had less of an impact on infrastructure as most assets are financed with long-term debt. However, the current higher interest rate environment may impact financing of future new infrastructure investments, despite inflation cooling down. Increases in interest rates on borrowing can make projects less attractive as the returns needed to service these rates are also set higher. Lenders are therefore likely prioritising high-quality assets and experienced counterparties.

The current financial crisis in the regulated UK water industry highlights some of these issues. An infrastructure sector of strategic importance, water industry assets are a common holding in core infrastructure portfolios. The UK water sector faces challenges from climate change, environmental regulations and macroeconomic uncertainty. The impact of regulatory intervention to limit price increases and demand major capital investment to address supply and treatment issues is proving challenging. High and sticky inflation combined with high levels of borrowing (leverage) raises significant questions as to the sector's attractiveness and even sustainability, especially with Thames Water entering special regulatory measures in July 2024.[14,15]

Some wider pullback in investment in the UK utility space has been reported due to uncertainties in the impact of Ofwat's draft determinations[16] and the impact this could have on other regulators. But the resultant impact on stronger firms in the sector is expected to be limited to some re-pricing of risk.

Investment in infrastructure has been constrained by asset allocation and supply limitations

The resilience of infrastructure investments to market volatility compared to other asset classes may have increased appetite in recent years. However, limits on the proportion of assets under management that can be allocated to various asset classes can also reduce inflows into infrastructure if portfolios. In 2023, fundraising for infrastructure projects slowed down as it reached asset allocation limits relative to other investments, with the value of infrastructure projects growing relative to other asset classes which were in decline, although this trend is expected to reverse over the next one to two years as other asset classes recover.[17]

Further allocation to infrastructure has potentially been slowed down by relatively high demand for what is currently a limited pool of high-quality assets. Increased interest in infrastructure investments from institutional investors in recent years has led to greater competition for quality infrastructure assets.

Policy and regulatory changes have been introduced to encourage allocation to alternative asset classes, including infrastructure, but it is not yet clear what the impact will be

Moves towards greater investment in productive finance and unlisted equities may increase pension funds' allocation to infrastructure

In 2021, the UK Government began a series of consultations on the use of illiquid assets in DC pension schemes, as a mechanism for generating better retirement outcomes and releasing assets to be invested in" productive finance". 2023 saw a parallel call for evidence on opportunities for improving access to DB funds and surpluses for investment in productive finance, either through direct investment or release of surpluses back to employers for investment in their businesses. In July 2023, the Government launched the Mansion House Compact. DC scheme signatories to the compact committed to the objective of allocating at least 5% of their default funds to unlisted equities by 2030. The specific wording is as follows:

> *"By signing this compact, founding signatories express an intent, on a voluntary basis, to take meaningful action within 12 months to secure better outcomes for UK long-term savers through facilitating access to the higher net returns that can arise from investment in unlisted equities, which will also benefit high-growth UK companies including but not limited to those operating in fintech, life sciences, biotech, and clean technology sectors."*[18]

[9] Milani, Mohr & Sandri [McKinsey] (2021) Built to last: Making sustainability a priority in transport infrastructure; OECD (2020) Transport Bridging Divides: Transport infrastructure trends and regional development
[10] Milani, Mohr & Sandri [McKinsey] (2021) Built to last: Making sustainability a priority in transport infrastructure
[11] Long-term Infrastructure Investors Association (2021) Social Infrastructure: from challenge to opportunity for investors
[12] Abrdn (2023) Emerging markets: should you invest?
[13] OECD (2022) Business insights on emerging markets

[14] Local Government Chronicle (18 Septemer 2023) UK water infrastructure – how should investors manage the rising sector risks?
[15] Gill Plimmer)2024) How bad in the crisis at Thames Water? (Financial Times, 12 July 2024)
[16] Ofwat, the Water Services Regulation Authority, is the economic regulator for the water and sewerage sectors in England and Wales. Their draft determination for PR24 is designed to push water companies towards greater efficiency, innovation, and customer satisfaction while ensuring environmental sustainability over the next 5 year period and contains explicit threats of financial penalties if companies fail to meet performance targets.
[17] Abrdn (2023) Infrastructure: How sustainability is focus of new investments
[18] www.theglobalcity.uk/PositiveWebsite/media/Research-reports/Mansion-House-Compact-Signatories-updated.pdf

It was calculated that this could unlock £50 billion of investment in high growth companies, although the commitment does not lock in providers to invest in the UK, so it may not necessarily have the desired impact on the UK economy.[19] The compact does not commit schemes to invest in infrastructure specifically, but some infrastructure is accessed through private equity, though how asset allocation is recorded varies by schemes; some may include infrastructure in their private equity allocation and others may split it out. Schemes are also likely to be looking more closely at investment in infrastructure as part of the drive towards more investment in productive finance. So, while some of the allocation to private markets may flow through to infrastructure projects, and these may have more focus generally as infrastructure plays a key role in growth companies; it is currently unclear what the scale of the potential uplift may be.

Alongside moves designed to increase investment in illiquids, private equity and productive finance, the Government has introduced a raft of measures (referred to as the Mansion House Reforms, and including but not limited to the Mansion House Compact), aimed at improving value for money and investment by DC schemes. These include the development of the new value for money framework, proposals for dealing with small deferred-member pension pots, the introduction of Collective Defined Contribution schemes and policies around investment.

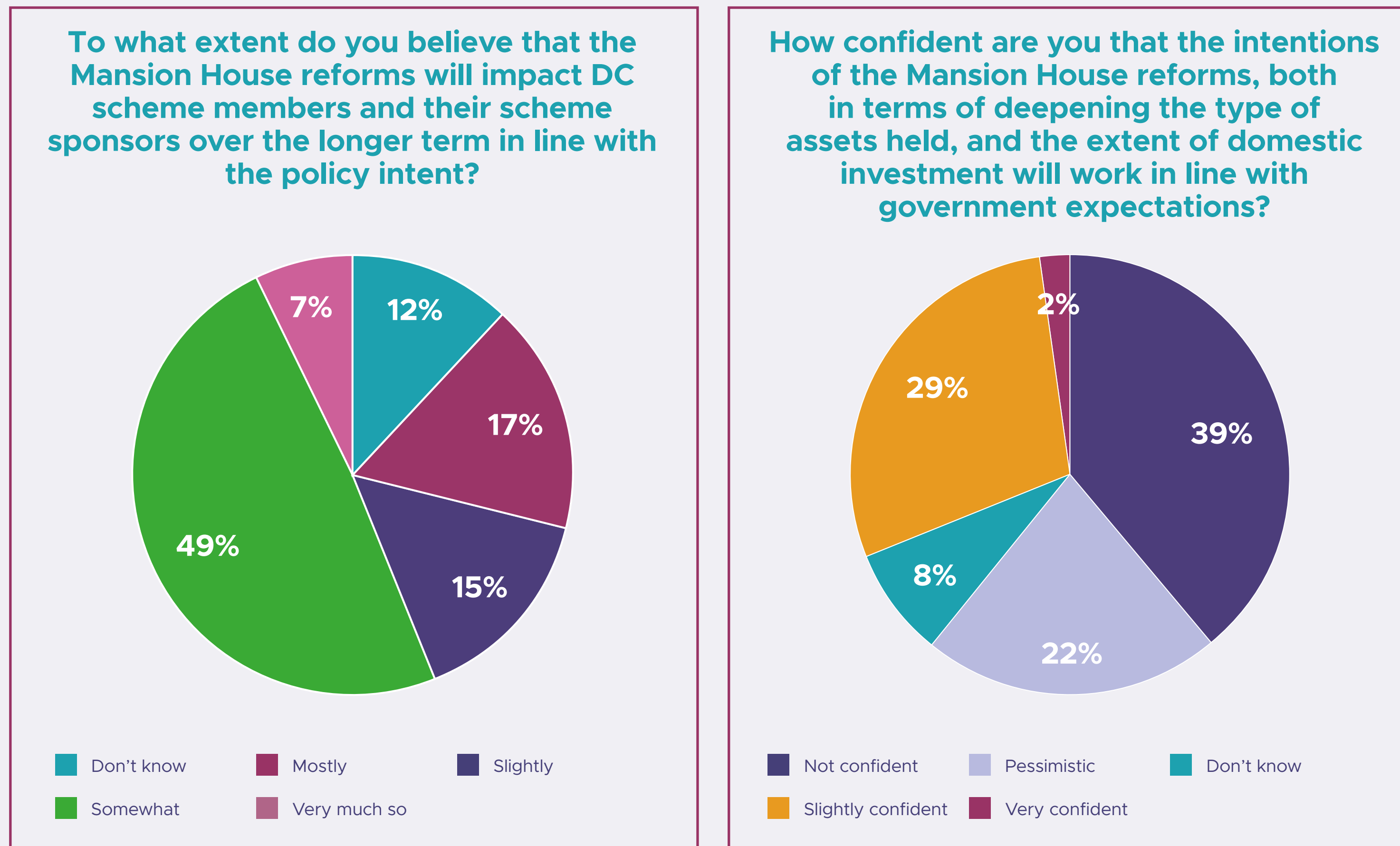
Expectations of the likely impact of the Compact and other moves are mixed. Almost two-thirds of pension funds surveyed in January 2024 expected to increase allocations to UK infrastructure over the next 12 months.[20]

A later survey in April 2024 found that only 17% of those surveyed thought that the mansion House reforms would impact DC scheme members and their scheme sponsors mostly in line with the policy's intent over the longer term, while half (49%) thought it would only align somewhat with the policy intent. 39% were not confident that the reforms would work in line with Government expectations, compared to just 2% who were very confident and a further 29% who were slightly confident (Figure 2).[21]

Figure 2

Expectations of the impact of the Mansion House reforms are mixed

PMI Pulse Survey April 2024



Changes to rules for inclusion of performance fees may allow for greater exploration of infrastructure assets

Infrastructure investments typically involve higher fees and expenses compared to traditional asset classes.[22] These fees may include management fees, performance fees and other expenses associated with sourcing, managing and exiting infrastructure assets. Pension schemes need to carefully evaluate the fee structure of infrastructure investments and assess their cost efficiency relative to expected returns.

There are also likely to be additional costs related to research, analysis and monitoring of infrastructure investments. High fees and other associated costs can erode investment returns and reduce the overall value proposition for scheme members. In particular, the returns for new infrastructure projects may also take some time to materialise, particularly in the construction phase. Infrastructure assets in the construction phase can also face the risk of unexpected cost overruns, delays in the construction process and interest rate risks if the project requires loans to get it through a lengthy construction phase.

The higher charges associated with investing in infrastructure have acted as a constraint to pension scheme allocation because of the charge cap of 0.75% on default funds. This cap includes scheme and investment administration charges but, since April 2023, trustees have had the option to exclude specified performance-based fees.[23]

The VfM framework is expected to deliver further consolidation to support greater scale, as well as a shift away from the focus on short-term costs, both of which could support greater investment in infrastructure

Having already introduced a detailed value for money assessment for schemes below £100 million in 2021, in 2023 the Government announced how its new new Value for Money (VfM) framework would work, and plans for phasing it in, providing a transparent and consistent way for schemes to assess their performance relative to others in the market. The framework covers three components: investment performance; costs and charges; and quality of services. The framework aims to shift the focus from short-term costs to long-term value, through requiring consideration of factors critical to longer term saver outcomes.[24]

It is expected that the introduction of the VfM framework will further accelerate the pace of consolidation among smaller schemes that may be underperforming. Consolidation of smaller schemes is a common feature of both the Australian and Canadian pension systems where pension scheme investment in infrastructure is greater. In addition to consolidation, the scale of master trust assets in particular is growing relatively rapidly as automatic enrolment continues into its second decade and savers who were newly brought into pension saving by the policy build greater levels of DC savings. As DC schemes achieve greater scale, either through consolidation or growing contributions, they may have more capacity for investment in infrastructure projects that are currently inaccessible to them.

[19] https://www.gov.uk/government/speeches/chancellor-jeremy-hunts-mansion-house-speech
[20] GLIL (2024) GLIL survey: Pension fund leaders plan infrastructure investment drive to support communities and fuel UK economy
[21] PMI Pulse Survey April 2024
[22] Gupta & Sharma (2022) Evolution of infrastructure as an asset class: a systematic literature review and thematic analysis
[23] This option is not available to contract-based schemes
[24] DWP (2023) Value for Money: A framework on metrics, standards, and disclosures

Some barriers to increased pension scheme investment in infrastructure remain

Levels of knowledge and expertise may not currently be able to effectively deal with the complexities of investment in infrastructure

Infrastructure investments can be complex and require specialised expertise to evaluate, structure and manage effectively. Investing in infrastructure requires thorough due diligence and specialised expertise to assess project viability, risks and potential returns. Pension schemes, particularly smaller schemes, may lack the in-house expertise and resources required to effectively assess and manage infrastructure opportunities. Outsourcing management of infrastructure investment to external managers or funds may entail additional costs and due diligence tasks. Larger schemes have greater ability to develop in-house expertise, as well as greater capacity to access external expertise when needed.

While on average across the whole asset class infrastructure investments are expected to provide long-term risk-adjusted returns, there are smaller subsets within the asset class that may present more risk and less return. It can be challenging to identify these potential risks before they materialise due to the rapid pace at which circumstances can change, such as the unpredictable pace of the energy transition and large-scale social change, such as the increased level of remote working.[25] Understanding the shifting level of risk associated with different infrastructure assets requires a sophisticated knowledge of the asset class and broader economic and societal factors. Some infrastructure assets may have shifted significantly on the risk-return spectrum as they are exposed to significant energy transition risk, such as gas pipelines, which were once seen as extremely stable and low risk investments. Some infrastructure assets have shifted in the other direction, such as digital infrastructure assets (e.g. mobile towers and fibre networks) that have moved down the risk spectrum as network communications technology matures. Investors need to move away from static technical assessments and financial models to an assessment that layers on wider factors for a thorough understanding of the risks and returns.[26]

There are questions as to whether there is yet a great enough coverage and level of knowledge to effectively engage with these increasingly complex decisions about allocation to infrastructure. However, it is expected that as scale grows in the DC market, the challenges posed by insufficiently available expertise should become less significant as these new capabilities are built over time.

Compatibility with ESG considerations can increase the complexity of investment in infrastructure

Infrastructure investment and Environmental, Social and Governance (ESG) considerations are becoming increasingly intertwined as investors recognise the importance of sustainability and responsible investing practices. This has been driven in part by increases in regulation on pension scheme investment in recent years as part of a wider social appreciation of these issues.

ESG risks exist across the infrastructure investment cycle for both new and existing assets. Investors are prioritising investment in infrastructure projects that contribute to climate change mitigation by promoting renewable energy sources, reducing carbon emissions and enhancing energy efficiency.[27]

Infrastructure can deliver positive social outcomes, providing an engine for growth in the economy, assisting in the transition to green energy and providing new services for communities, while at the same time delivering a reliable risk-adjusted return for investors. Schemes' fiduciary duty to members, combined with increasingly important ESG considerations, mean that finding investments that can deliver both social or environmental good and positive returns is a central goal of pension schemes at present.

[25] Brinkman & Sarma [McKinsey] (2022) Infrastructure investing will never be the same
[26] Brinkman & Sarma [McKinsey] (2022) Infrastructure investing will never be the same
[27] Environmental Audit Committee (2023) The financial sector and the UK's net zero transition

However, some infrastructure projects present a tension between social and environmental factors that needs to be balanced. Infrastructure projects can often have substantial environmental footprints, for example, many are heavy in use of environmentally unfriendly materials like cement.

90% of UK pension funds surveyed in January 2024 planned to increase their allocation to renewable energy in the next 12 months, while the remaining 10% said they might make increases.[28] However, there is also a limited supply of UK-based green infrastructure/energy transition projects available as the UK's climate conditions not optimal for these projects. Nevertheless, the UK tends to be advanced at developing new technologies for renewable energies and that is being invested in, rather than infrastructure projects themselves.

Investors also need to consider the potential risk posed to infrastructure assets by extreme climate events which are increasing in frequency and severity, as well as longer shifts in climate patterns. To date, investors have been primarily focused on the transitory risks of climate change (regulatory changes, etc.) rather than the physical risks, but these will become an increasingly important consideration when assessing risk and return of infrastructure investments.[29]

Closed DB scheme targeting buy-out will not hold infrastructure assets

Full buyout is the most common long-term aim amongst larger DB schemes with 38% targeting this in 2023 as their long-term objective, compared with only 11% in 2015. All these schemes were aiming to complete a transaction within the next 3 years. Nearly one-half (46%) of all larger DB schemes had already implemented or were currently investigating an investment strategy to target buyout. A further 15% were considering it as a potential future strategy and more than three quarters (76%) of large schemes were monitoring their buyout funding level on a quarterly basis.[30]

The investment priority for schemes targeting buyout is to make their asset portfolio attractive to transfer to an insurer. Insurers are subject to the solvency requirements of Solvency II and other UK prudential regulation. Suitable portfolios would typically have more liquid assets, such as cash and a segregated portfolio of public bonds which are Matching Adjustment (MA) eligible.[31] This largely precludes investment in illiquid alternative assets, such as infrastructure, and any assets not fitting the transfer criteria will be divested to implement a buyout-friendly portfolio. Generally, there is little overlap between pension scheme illiquid assets and the illiquid assets that meet insurers' solvency requirements.[32]

Insurers do have mechanisms to help schemes divest illiquid assets. There are a minority of instances where an insurer will take on a very specific asset, but they are more likely to facilitate access to secondary markets, via a partner. A further option is to arrange a deferral of part of the buy-out premium where an illiquid asset is going to run off in the near future. But in a market where buy-out capacity is limited, our discussions suggest that insurers will inevitably prioritise portfolios that better meet their solvency criteria.

Public Sector DB has a growing interest in infrastructure investment, albeit from a low base, as capabilities develop

Public sector DB, particularly Local Government Pension Schemes (LGPS), are showing increasing interest in infrastructure as a diversifying asset and source of investment income. This interest is strengthened where the impact that the resulting investment can be directly linked to environmental, economic and social policy, particularly in local communities, though specific projects, for example, in renewables and sustainable energy transformation. These twin aims of diversified investment returns and visible social impact make infrastructure an attractive proposition for public scheme trustees and their members.

[28] AlphaReal (2024) UK pension funds and insurers to boost renewable infrastructure investment
[29] 4D Infrastructure (2023) Global matters: Extreme weather risks and their impact on investors
[30] Pensions Age (26 July 2024) Growing number of DB schemes targeting buyout
[31] The Matching Adjustment in Solvency II regulations allows insurers to reduce the capital requirements associated with portfolios by increasing the discount rate for annuity business when backed with eligible assets and hence to allocate capital more effectively
[32] Phoenix group (2024): Managing illiquid assets during a bulk purchase annuity transaction accessed at https://library.standardlife.com/DB-Solutions-report-managing-illiquid-assets-bpa.pdf

LGPS infrastructure investment is being enabled by growth of investment pooling within LGPS. This is being strongly encouraged by Central Government so as to save cost and enjoy the benefits of scale. Building large pooled funds also brings portfolio construction capabilities, providing a more diversified pool of investments and managers than individual schemes can access. The investment pools are building out their teams to enable a wider range of more specific funds to be offered that can be tailored to the investment and social impact criteria of partner LGPS, their local communities and members.

Other large public sector DB schemes have invested in infrastructure attracted by reliable, inflation-linked returns, as part of the wider trend to investment in non-public markets and have developed dedicated teams to manage, co-invest or directly invest in infrastructure.

Bulk annuity insurers are well placed to expand infrastructure investment in the UK but only as the right opportunities arise

For bulk annuity insurers, infrastructure is now regarded as a core part of the asset mix. They are attracted by the long duration of the assets as a good match their annuity liabilities. They regard infrastructure as a defensive asset with predictable and highly regulated cashflows. Appetite for more investment in infrastructure is said to be strong whilst it continues to promise additional returns over other similar public and private market assets, particularly where such investment meets ESG and Net-Zero criteria. Investment is currently seen as constrained by the capacity to find and take on new assets.

They have built up dedicated infrastructure debt teams who are actively speaking to market participants, such as equity sponsors and banks (such as the UK infrastructure bank), in order to find opportunities that meet their investment parameters. Interviewees reported that, at the moment, there is a shortfall of suitable assets in the UK and that investment teams spent much of their time seeking out new opportunities and trying to increase capacity in the infrastructure market through helping projects to come forward. Specific issues cited include the limits on the capacity of equity sponsors and planning restrictions.

The growth agenda of the new UK Government is seen as a positive development with some expectation that this will result in more projects and investment in the infrastructure sector in areas such as social housing, renewable energy and power distribution. There is also expected to be more investment opportunities more generally as the sector recovers from the recent interest rate shocks and resultant cost of living crisis and delayed projects flow back into the market. Some also had concerns that the more stable political outlook might also attract more foreign investment into the UK market with a potential compression of returns from infrastructure for new UK investors and hence a reduction in the attractiveness of the sector.

UK investors will have some preference for UK over US or European assets as the resulting cashflows are in sterling and so portfolios have been historically more UK focussed. Non-UK assets form a much smaller proportion as the resultant non-sterling cashflows are typically fully hedged to manage the currency risk, resulting in additional costs. Nevertheless, if non-UK assets can deliver relative value with hedging applied and it meets the other investment parameters, then they will be added to the portfolio.

Solvency regulation is moving cautiously to support wider role for infrastructure assets for bulk annuity insurers

Reforms to the Solvency II Matching Adjustment (MA) regulations were implemented on 30 June 2024 that are relevant to insurers in the bulk annuity market assuming DB liabilities. The reform widens eligibilities for MA from assets with fixed cashflows that cannot be changed to include assets with 'highly predictable' cashflows,[33] subject to safeguards[34] but with a 10% cap on total MA benefit. This is expected to favour certain secure alternative investments, in particular infrastructure.[35]

Conclusion

Investment in infrastructure is set to increase over the coming years, as pension schemes mature and capabilities develop, provided that investment managers and advisers continue to have consistent expectations of additional returns for holding these complex and illiquid assets. Given these conditions, the additional ESG impact of these holdings adds to their attractiveness for trustees, sponsors and members.

The greatest appeal lies with schemes and specialist insurers who hold, and expect to continue to hold, the liabilities for closed DB schemes. For them, infrastructure offers predictable and inflation-linked cash flows to pay retired members pension incomes. In the specialist bulk buy-out insurers, infrastructure is expected to form a significant core holding limited currently by the availability of suitable projects and their capacity to bring these under management.

For large open DB schemes, there is also investment taking place, and developing capabilities to do so, with the expectation of infrastructure making a contribution to the diversity and resilience of investment returns in the overall asset mix. The ESG impact is also a favourable factor.

For DC, infrastructure investment requires the achievement of scale in schemes to develop the specialist management capabilities and purchasing power to make an infrastructure attractive and cost-effective component of the asset mix. Initiatives by Government to stimulate consolidation and a changing emphasis by the Pensions Regulator to balance returns with fees as part of the VFM agenda could contribute to speeding these processes over the medium term.

However, for policy to monitor and assess the development and impact of infrastructure as an asset class on outcomes for members, there is also a clear need for better processes and mechanisms to define and collect consistent data on infrastructure allocations and performance within and across schemes.

[33] To be eligible, assets would need to be (1) contractually bound in timing and amount (2) be bonds or have bond-like cashflow characteristic (3) be capable of receiving either an external or internal credit rating
[34] These include additional risk management, modelling, governance and disclosure requirements
[35] KPMG (2024): Solvency II – Matching Adjustment reform accessed at https://kpmg.com/xx/en/home/insights/2023/10/solvency-2-matching-adjustment-reform.html

Pension scheme assets deep dive series #2

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