Spotlight on Pensions

PRESENTS

Le Grand View

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Infrastructure Investment with Members' Pension Funds – Handle with care

The UK is facing a chronic infrastructure investment challenge. Decades of underinvestment in key sectors, combined with the need to embrace new technologies, has created a multi-billion-pound investment gap which needs to be filled urgently. Should pension funds become involved?

Broad definition

The definition of infrastructure varies but is potentially very wide. The list of projects in the UK currently requiring funds is long and certainly includes such things as:

- New housing, particularly in the social sector
- Broadband rollout and upgrade
- New and upgraded railways, roads, and other transport projects such as a national network of electric vehicle charging points
- New power generation sources
- New hospitals and schools
- Environmental protection projects, from flood relief schemes to clean water provision and sewage treatment.

In addition, issues arising from increasing population, climate change and societal changes following the pandemic are overlaying a further set of new requirements upon virtually every aspect of current life. As a result, most infrastructure is potentially in need of attention earlier than previously expected.

Funding sources

In situations involving a wider public interest, there is a strong case for state investment. However, the size of the current investment shortfall means that the political appetite for using state-raised funds to meet more than a small proportion of the total is limited. Tax increases are a difficult sell and scope for further increased borrowing is severely limited following huge expenditure (so far) on state pandemic-easing financial measures. Current very low interest rates ease borrowing costs in the short term, but the funding requirement of many projects is longer-term.

Political considerations are also closing off a number of potential funding sources from overseas states, as shifts in global power balances raise security concerns.

Non-state funding is not a new phenomenon and private sector sources will be tapped again. Already the Government is looking enviously at the huge aggregate funds held in pension arrangements and making overtures to influence those controlling the funds to help out. The pressure on schemes will only grow, driven by post-Brexit challenges and Government policies such as "build back better" and "levelling up".

Risk vs return

Trustees and managers are beginning to respond positively. The decision to invest however is not necessarily a straightforward one. Within such projects, the "public interest" aspect can lead to a dilution of returns. Some projects can also be more speculative, increasing risk. The private sector is comfortable with financial risk and is able to handle it, provided it is accurately identified and appropriately balanced against potential reward. However, the nature of many infrastructure projects presents particular difficulties when it comes to accurate financial risk assessment.

Much of our current infrastructure owes its beginnings to private investment. Canals and railways are prime examples. The ground-breaking nature of many projects made their financial outcome difficult to predict. Whilst some visionary entrepreneurs were rewarded with huge fortunes, many more investors suffered losses. These losses were critical where investors overcommitted through a failure to understand the full nature and extent of the risks involved. History shows that many projects carry a high risk factor.

Public Private Partnership and PFI contracts used extensively in the early years of this century generally provided more secure returns for investors, but many believe that the balance was weighted too heavily in favour of private investors, at the expense of the public purse. Consequently, the terms of future new contracts are likely to be less generous for the private investor.

Lower returns or even losses are not a problem in principle where the investor understands the risk and accepts it in the expectation (hope?) of a good profit. However, history is also full of cases where the risk was not fully understood and knowingly accepted, leaving the naïve investor in unexpected, serious financial difficulty. Even more experienced investors can be caught out, as the sub-prime mortgage crisis of 2018 graphically demonstrated.

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Pension fund involvement

Large defined benefit pension schemes have long been infrastructure investors. They have generally invested sparingly, in large projects carefully researched utilising the resources afforded by their size. Investments have generally been in stable projects providing a safe steady income and matched to the particular liabilities of the scheme.

The large size of many projects also meant that only the largest schemes had sufficient funds to invest on their own, limiting the amount of pension monies available to the sector. However, the growing development of bundled solutions, combined with the movement towards consolidation of schemes – even in the defined contribution sector – means that the potential for using pension fund monies is growing.

There was uncertainty over the extent to which pension funds held under trust could – let alone should – invest in projects with social elements, where ultimate profit is not necessarily the sole focus. However, following a Government request for a review of the law, the Law Commission published a report in 2017 concluding that schemes are free to invest where for example a majority of members were likely to support particular investments. This potentially opens the door to greater scheme involvement.

In the case of contract-based arrangements, based upon the underlying principles of agreement between equal and consenting parties, no such general concerns existed. However, given the generally low levels of members' financial knowledge, it cannot be said that members and managers contract as equals in this respect. Consequently, the more cautious approach of trust-based schemes arguably should also apply in the contract-based world.

Arrangements, whether trust or contract-based, where individual members have investment responsibility account for a large and growing proportion of the whole since the arrival of automatic enrolment.

To invest or not?

So, given the specialised nature and particular circumstances of infrastructure projects, is this a suitable sector for pension fund investments? Are the particular risks and possible lower returns (even if fully understood and accepted) compatible with a funding plan to provide retirement incomes?

The answer overall is probably a qualified "yes" – but the qualifications are crucial to the equation. Perhaps the most crucial requirement is a proper understanding of the particular characteristics of the proposed investment, and how it will fit with the investment objectives of the scheme or the individual member. This of course is always the case, but with such a specialised sector the process of achieving an accurate assessment is more difficult.

As ever larger schemes, with their ability to fund the most thorough bespoke research, are probably the best placed in this regard. Dropping down the size range, the ability to fund the cost of appropriate research and consideration decreases. This has important consequences, given increasing legal pressures on trustees to ensure their investment choices are properly researched, considered, monitored, and reported on. This will undoubtedly be used as another stick with which to beat schemes down the consolidation route, but very significant consolidation will be required to make a difference here.

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The biggest concerns exist in respect of schemes where investment decisions fall upon the individual member. Realistically, given the widespread poor financial knowledge of members, a full understanding of the nature of those investments is impossible to achieve. Most members themselves effectively recognise this by allowing their pension savings to be placed into default funds on their behalf. Consequently, those default funds have a particular responsibility towards members' pension security.

Proceed with caution

Individual members, if asked to consider the point, may express support in principle for an investment strategy for their pension funds that incorporates some element of what they might consider to be "good citizenship". That answer may still hold even if they understand that there may be a cost in the form of a reduced return. Fund managers may feel that this authorises the use of such investments in portfolios, in line with the principles expounded in the Law Commission report.

However, there is a widespread problem in the UK with the small size of members' pension pots. Initiatives to encourage greater contribution levels to address this have so far had limited success, placing a greater emphasis on funds to give the best possible returns. This may include recognising that even if members appear to indicate that they are not necessarily focused on high returns at any cost, it may ultimately be in members' best interests to chase those higher returns as a priority.

From the Government's perspective, pressuring schemes to invest may appear to provide strong benefits for the country in the short term. However, if significant tranches of members reach retirement age with substandard pensions, the impact on tomorrow's UK state finances may be at least as great as that presented today by infrastructure investment shortfalls. This point should be borne in mind when chasing pension schemes for investment.

For schemes, getting the balance right in each case will be a challenge. Schemes will need to proceed with particular care.

For more information on Spotlight on Pensions contact Pendragon

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