

Department for Work and Pensions

Response by email to [caxtonhouse.dbcfe@dwp.gov.uk](mailto:caxtonhouse.dbcfe@dwp.gov.uk)

5 September 2023

### Response to Options for Defined Benefit schemes: a call for evidence

We, the Association of Real Estate Funds<sup>1</sup> (AREF), welcome the opportunity to contribute to the evidence being collated by the Government to enable DB pension schemes to use their assets more flexibly. We are not in a position to respond to most of the matters raised in the call for evidence as this sits outside our area of expertise. We would, however, wish to raise one specific but important point in respect of Question 2.

***Question 2: What changes might incentivise more trustees and sponsors of DB schemes to consider investing in productive assets while maintaining appropriate security of the benefits promised and meeting their other duties?***

Our point relates to incentives to trustees and sponsors of DB schemes to consider investing in productive assets. Our experience from the real estate investment management industry is that trustees and sponsors of DB schemes are currently incentivised to do the opposite. We believe that DB schemes are rapidly reducing their allocations to real estate and other productive but illiquid assets. This is a response to the journey to run-off and the desire to be able to transfer obligations in the insurance bulk annuity market. Investments in assets that do not fit within the Solvency II Matching Adjustment regime are generally not attractive to participating insurers. We have raised separately with HM Treasury and the Prudential Regulation Authority (PRA) changes that are being made to the Matching Adjustment in reforms of the UK Solvency regime (see Annex 1). Without change, DB schemes will continue to dispose of productive assets to facilitate transfers to insurers. Changes to the Matching Adjustment is part of the answer, but a wider range of options for DB schemes is also important. Consolidation of DB schemes would allow greater access to the skills needed to invest in less liquid assets. It may also facilitate the run-off of pension liabilities outside an insurance regime and this may, in turn, facilitate greater investment in productive finance.

If you would like to engage with us further regarding our response, please contact either myself ([prichards@aref.org.uk](mailto:prichards@aref.org.uk)) or Jacqui Bungay ([jbungay@aref.org.uk](mailto:jbungay@aref.org.uk)), Policy Secretariat, AREF. In addition, members of our Public Policy Committee are always willing to assist the FCA by sharing their wealth of knowledge and expertise in respect of real estate funds.

Yours sincerely



Paul Richards

Managing Director, The Association of Real Estate Funds

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<sup>1</sup> The Association of Real Estate Funds represents the UK real estate funds industry and has over 50 member funds with a collective net asset value of more than £50 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the AREF Property Fund Vision Handbook.

## Annex 1

### Property industry submission on Solvency II matching adjustment reform

#### *Introduction*

We write as a group of associations representing the real estate industry in the UKA sector – an industry which contributed more than £107bn to the economy in 2020 and supported 2.3 million jobs.

As owners, investors and developers of places up and down the country, the real estate sector has a hugely important role to play in supporting the Government’s policy aims around decarbonisation and levelling up. Both of these long term projects will require significant private sector capital investment, sustained over a period of many years, if they are to be successful.

We therefore welcomed the Government’s review of Solvency II and support its conclusions and objectives of ensuring policyholder protection and supporting insurance firms to provide long-term capital to underpin growth.

#### *Insurance investment in real estate*

Real estate is an attractive investment for long term life insurers; it can provide stable, regular and predictable levels of income over long periods of time and it provides diversification benefits away from the equities and bonds that form the mainstay of their investment portfolios. Depending on the type of real estate, rental income can be index-linked and therefore provide a good hedge against inflation.

Insurers are important investors in the UK’s towns and cities, with an estimated exposure to real estate of well over £150bn through direct and indirect (i.e. through funds and other collectives) investments.<sup>2</sup>

Our insurance-backed members tell us they are keen to commit more capital towards building new homes to rent and developing more dedicated housing for seniors. They are also interested in entering into long-term partnerships with local authorities on town centre regeneration projects. As well as providing income for policyholders, this new investment would deliver substantial economic and social benefits to the UK as a whole.

#### *Matching adjustment reform*

HM Treasury’s *Review of Solvency II*, published in November last year, set out important changes as the UK introduces its own solvency regulations for insurers (Solvency UK). This includes increasing investment flexibility in eligibility for the matching adjustment. Crucially, this includes loosening the requirement that investments generate fixed cashflows to a requirement that investments generate highly predictable cashflows. This change will mitigate the need to structure investments to create an instrument with bond-type fixed cashflows from an underlying investment with highly predictable cashflows.

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<sup>2</sup> *The Size and Structure of the UK property market*, IPF, April 2022 (link [here](#))

HM Treasury's comments refer to specific economic infrastructure and green assets. We assume that these are intended to be examples and that other assets with similar cashflow characteristics will also be eligible. In particular, life insurers already invest in long-lease commercial and residential real estate, structuring instruments to generate fixed cashflows that are eligible for the matching adjustment. However, as recognised in the *Review*, this structuring adds time and cost to the investment.

Ensuring that real estate assets with highly predictable cash flows are eligible for the matching adjustment without the complexity of creating fixed return instruments will reduce cost and complexity for insurers and meet the government's objective of increasing long-term investment in commercial and residential real estate, necessary for achieving the levelling-up agenda.

Widening the pool of assets eligible for the matching adjustment would also assist de-risking by UK defined benefit (DB) pension schemes. The UK's private sector DB scheme liabilities are estimated to be £2 trillion. These liabilities are increasingly being transferred to insurers via the pensions bulk annuity market. Capacity constraint is a major challenge, which is why widening eligibility for the matching adjustment is key<sup>23</sup>. Enabling 'income producing real estate' to be eligible and efficient would help increase capacity.

To unlock the benefits of greater insurance company investment into real estate, we make the following suggestions:

1. **Meaning of "highly predictable":** While moving from fixed to "highly predictable" cash flows is welcome, we believe that it would be helpful it could be confirmed that real estate with these characteristics is also eligible.

When the PRA is approving assets eligible for the matching adjustment, we would suggest that insurers be able to take a principles-based approach to assessing whether cash flows meet this standard. In a property context, considerations could include:

- a. The creditworthiness of the party(ies) making the payments and their ability to withstand stressed economic or sectoral conditions (and also the ease with which such parties can be replaced with minimal interruption to cash flows);
- b. The type of underlying asset and related supply/demand dynamics;
- c. The conditions of the contract with the party(ies) making the payments (e.g. frequency/regularity of payments, the ease with which it can be terminated and the existence of terms requiring payment in full for termination);
- d. Force majeure risk (e.g. susceptibility to fire/flood/civil unrest);
- e. Design and technology risk (for new developments);
- f. Construction risk (for new developments).

We would refer also to the comments made in July 2020 by the Matching Adjustment Working Party of the Institute and Faculty of Actuaries (the IFA MA WG) regarding the matching adjustment's treatment of property investments.<sup>4</sup>

The predictability of the cashflows should be considered for the lease in its entirety rather than purely in respect of the income element. In many cases the returns from a real estate asset including the value of the reversion at the end of the lease will be highly predictable.

2. **Eligible property leases:** As noted above, while the *Review* refers to economic infrastructure and green assets, we assume that these are intended as examples and that other assets with highly predictable cashflows would also be eligible for the matching adjustment.

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<sup>3</sup> Hymans Robertson annual Risk Transfer reports [2022](#) and [2023](#)

<sup>4</sup> [Challenges for insurers running Matching Adjustment portfolios – July 2020](#)

It should be therefore clear in legislation and relevant PRA guidance that contracted income arising under property leases can be eligible for the matching adjustment where the associated income is highly predictable as assessed using principles like those set out above. This would include long leases to strong covenant strength tenants such as national and local government, strongly rated corporate occupiers and others. In this regard, we support the IFA MA WG's comments in December 2021 regarding how the matching adjustment could apply to a property sale and leaseback investment<sup>4</sup>, although we believe that this treatment is equally applicable to other long lease arrangements.

The real estate industry already has established practice for determining the predictability of returns for "long-income" funds, for example industry consensus that contracted lease length should be at least fifteen years.

- 3. Treatment of development projects:** To incentivise insurers to invest in developing new property assets, there should be a less penal approach to allowing some matched fund capital to be invested in development-stage assets. Again, the IFA MA WG explored this topic in their December 2021 paper, albeit their focus was on infrastructure assets with a construction phase. However, the principles and approach they propose are ones that we would argue apply also to both commercial and residential property developments.

## **About the signatory organisations**

### *Association of Real Estate Funds*

The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of more than £64 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the AREF Property Fund Vision Handbook.

### *British Property Federation*

The British Property Federation (BPF) represents the real estate sector – an industry which contributed more than £107bn to the economy in 2020 and supported 2.3 million jobs. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them. Their investments help drive the UK's economic success; provide essential infrastructure and create great places where people can live, work and relax.

### *INREV*

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. With approximately 500 members, including institutional investors such as pension funds, insurance companies and sovereign wealth funds from around the globe, as well as investment banks, investment managers, fund of funds managers and advisors, we represent all facets of institutional investment into real estate in the UK and Europe through non-listed investment funds, joint ventures, club deals and separate accounts.

### *Investment Property Forum*

The Investment Property Forum (IPF) is an individual members organisation for those operating in the UK property investment market. Our membership of 1,800 includes investment agents, fund managers, bankers, lawyers, researchers, academics, actuaries and other related professionals. The IPF's mission is to enhance the understanding and efficiency of property as an investment, including public, private, debt, equity and derivatives, for our members and other interested parties, including government, by undertaking research and special projects; providing education; and providing a forum for networking, discussion and debate amongst our members and the wider investment community.