

# The power of pensions

How pension savings can help to build the UK's infrastructure and drive growth in all regions

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# Introduction

## The last few months have dramatically impacted the lives of people, their communities and the economy of the UK.

The fundamentals that were clear to us all before the COVID-19 outbreak remain. The UK needs investment in infrastructure, particularly in projects that have a direct impact on how we live and work. These investments are key to the long-term competitiveness of the UK economy.

The Government was right to recognise this in the significant spending plans it announced in March's Budget, and we look forward to seeing further details in the next National Infrastructure Review. However, the potential impact of COVID-19 became evident within weeks of that statement. Priorities are now on underwriting parts of the economy and restoring the nation's financial health. While investment was needed before, it is even more pressing now and insurance firms such as ourselves are ready to step in with a significant amount of long-term capital.

Now is the ideal time to invest in infrastructure as we deal with the economic consequences of COVID-19 and the lockdown of our commercial life. The activity that these investments would generate will help to stimulate the economy both at a macro and micro level, generating jobs and new opportunities for businesses and individuals across the country.

Through constructive collaboration with the Government at national and local level, the private sector can step up to provide the nationwide infrastructure investment the whole country desperately needs.

At Legal & General, we are committed to what we call 'inclusive capitalism' – that is capitalism that improves everyone's life by boosting the economy from the ground up, by sharing our success with investors, customers and wider society. This is at the heart of our investment decisions – and has been for many years.

Predictions suggest that between 2020 and 2030 there is going to be a £1 trillion infrastructure funding gap in the UK.<sup>1</sup> We believe that we – together with other insurers and pension funds – have the potential to provide considerable capital funding by using Pension Risk Transfer (PRT) funds to invest in infrastructure throughout the UK.

The provision of a regulatory framework and local project support, together with a renewed government focus and commitment to collaborate with the private sector will enable insurers to easily invest in UK infrastructure.

If the UK wants to deliver productive growth quickly, the focus should be on utilising the billions available from firms like ours to invest in 'midi-projects'. Valued at between £100million and £1 billion, 'midi-projects' could help deliver a levelling-up agenda across the UK – that means more jobs and productive growth to benefit everyone. The benefits to the economy and society could be profound – not in ten years' time, but now, when it is needed most.

By specifically harnessing the pensions wealth we already have in this country, we can deliver regeneration, transport, housing and renewable energy investment. Doers, such as Legal & General, can be a catalyst for delivering a more inclusive form of capitalism using the power of pensions.



**Nigel Wilson,**  
Chief Executive,  
Legal & General Group

1. Internal estimates based on Legal & General data and the contents of the National Infrastructure Plan

# Executive summary

There are three 'mega gaps' that hold back our economy from being truly inclusive: infrastructure, age and carbon.

It is worth at this point defining what we mean when we say 'infrastructure'. To us, this includes the roads, railways and power that connect us, as well as the housing and regenerated towns that can provide everyone with a good standard of living.

To improve our infrastructure the UK needs to invest in projects such as fibre optic networks; clean, green and low-cost energy; affordable housing; urban regeneration and low-carbon transport. Doing so will stimulate productivity, turbo-charge regional growth and boost real wages.

Historically, banks and Government were traditional sources of infrastructure investment. However, this is less frequently the case, especially as in the coming months and years the

Government's attention and funding is likely to be focused elsewhere as we realise the true impact of the COVID-19 pandemic. So, where can the money come from?

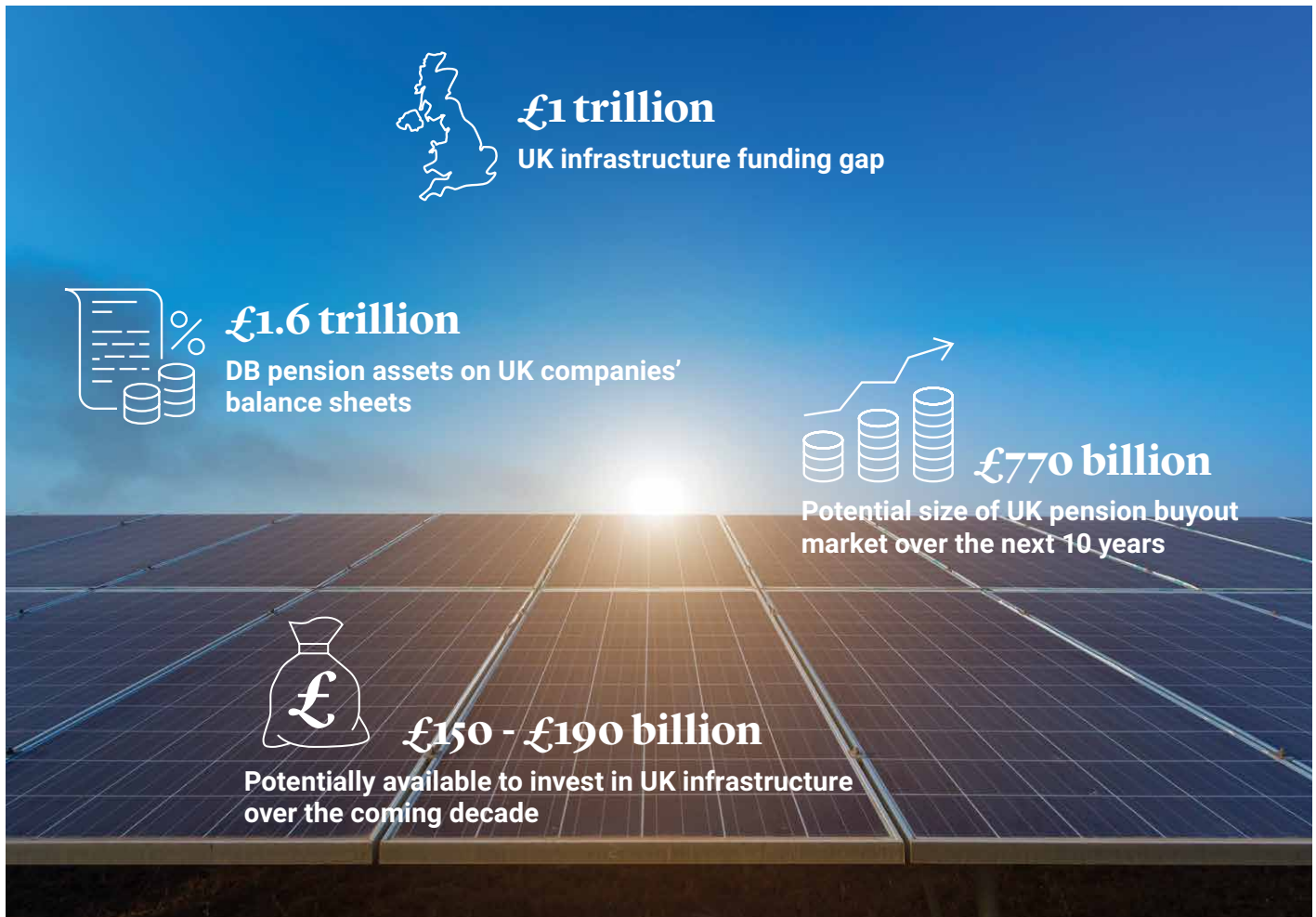
## Company and private pension schemes

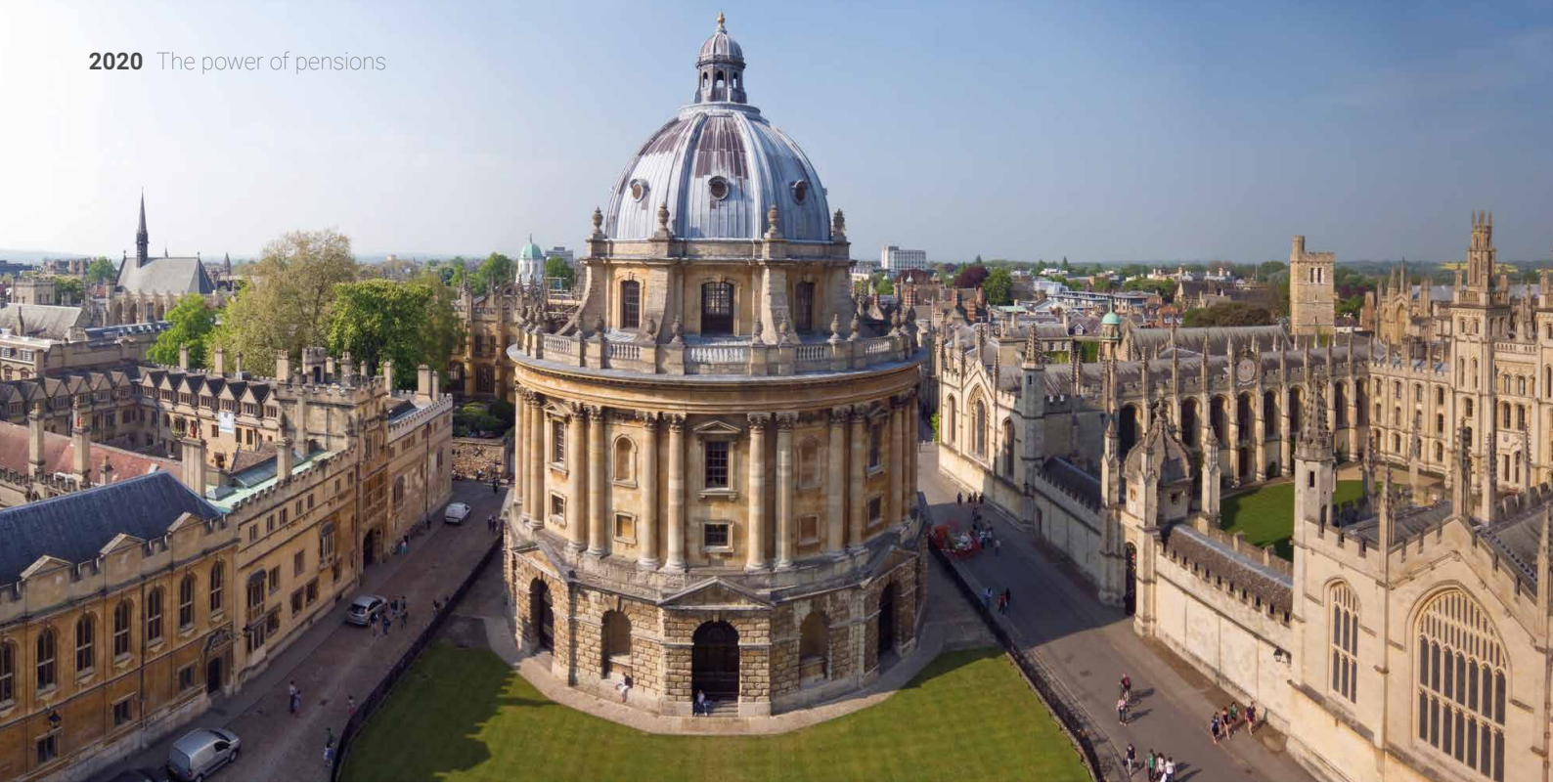
Both Defined Benefit (DB) and Defined Contribution (DC) schemes need to invest their funds to generate the returns that pay their members' income.

## Pension Risk Transfer (PRT)

A significant and growing number of companies are 'de-risking' their DB, or final salary, pension schemes through what we call 'Pension Risk Transfer' (PRT). This is where a DB pension scheme pays a premium to an insurer such as Legal & General to secure some, or all, of their members' retirement benefits.

## The answer lies in our shared savings: pensions.





### DB scheme assets

The UK PRT market has de-risked more than £64 billion in the last two years alone, and over £130 billion over the entire history of the market.<sup>2</sup>

This, however, represents only a small proportion of the estimated remaining £1.6 trillion in DB scheme assets in the UK.<sup>3</sup>

The Pensions Policy Institute (PPI) estimates that £770 billion could come into play in the PRT market leading up to 2030.<sup>4</sup>

### Potential infrastructure investments

Legal & General estimates that between £150 billion and £190 billion could be invested in infrastructure by insurers and other providers of PRT to back their pension commitments over the next decade.<sup>5</sup> This would make a significant contribution towards plugging the UK's infrastructure gap over the course of the 2020s and aligns with the Government's commitment to encouraging growth and raising living standards across all parts of the UK.

Long-term infrastructure investments are often very attractive to insurance companies because they provide secure and steady cash flows for paying pensions as they fall due. The cumulative size of the pension funds available enables us to diversify and spread any potential risk. Alongside the long-term nature of pension provision, this means PRT providers in particular are ideally placed to invest significant amounts in infrastructure projects.

### Legal & General investments

At Legal & General, we are already showing that pension funds, and our own balance sheet funds, can be invested in real assets,

real jobs and real skills that will deliver real wage increases. We have already invested almost £26 billion in 'Future Cities', clean and low cost energy, housing and infrastructure.

To give a recent example, we agreed a £4 billion partnership with Oxford University to help the city of Oxford and the university to achieve their global ambitions through better research facilities, more housing for academics and better infrastructure for the city's people. In April 2020, we invested £150 million into Sheffield's West Bar Square development which will provide 350 'Build To Rent' homes, currently lacking office space for 1,800 workers, a multi-storey car park and high quality landscaped public spaces.

We have also invested in projects in Bristol, Cardiff, Salford and Newcastle-upon-Tyne. The Newcastle Helix aims to become a major UK hub for scientific research, and technology businesses, creating local knowledge-based jobs for future generations.

Many of the biggest investment opportunities lie outside of London and the South East.

### Enabling future investments

Investing in infrastructure will not only help provide the long-term returns that allow insurers to guarantee pension members' benefits, but will also contribute to the success of UK plc.

Insurers have a significant investment appetite, but if this contribution is to be realised, then Government at all levels, working with the private sector, has to play its part in supporting this. How this should be done is examined in this report.

2. Based on Legal & General's analysis

3. PPF Purple Book 2019

4. Approaching the endgame: The future of Defined Benefit pension schemes in the UK, Pension Policy Institute

5. Prediction by the Legal & General Retirement Investment Solutions team based on current back book allocations, current infrastructure investment volumes and likely sector limits imposed on investors

# The virtuous circle

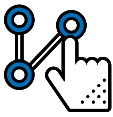
## The mega gaps

There are three mega gaps which are important for the UK to realise inclusive capitalism.



### The first is age:

We must see the ageing society as an opportunity to rewire the economy that will soon have more people over 65 than under 18.



### The second is infrastructure:

Old infrastructure, and old-fashioned thinking, is holding back productivity and the creation of new real assets.

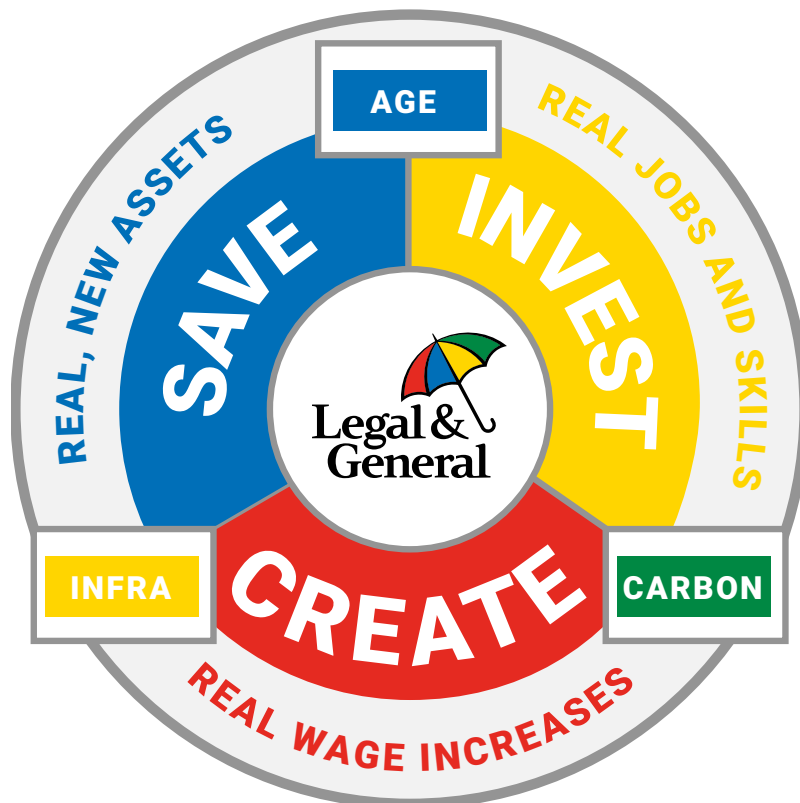


### The third is carbon:

The economy needs to undergo a huge programme of decarbonisation in every home, every business – in every part of society - and a continual move towards clean and green energy.

## How do we successfully close these gaps?

We believe that Legal & General and other insurers are already playing their part in doing so. Deployment of funds can create a virtuous circle of older UK savers funding infrastructure assets that provide a public service, increase the productivity of the wider economy and generate the right level of returns to fund pensions.



# Using pensions to fund UK infrastructure



## The changing pensions landscape

The nature of workplace savings has changed dramatically over the past decade, resulting in a pensions system that offers a much stronger long-term future.

### Different types of pension schemes:

Defined Contribution (DC) and Defined Benefit (DB) are the two main types of pension schemes. With a DC scheme, there are set minimum contributions for both the employee and employer and these contributions are both invested in an individual account, with the policyholder being able to use the resulting funds for their retirement. A DB scheme, on the other hand, is different. With these schemes, an employer or sponsor promises a specified pension payment or sum to a policyholder. This is typically calculated based on the employee's earnings history, length of service or time in the scheme and age – rather than being based on what the individual puts into the scheme.

It is clear that we need to get the best out of all parts of the retirement ecosystem if we want it to deliver for a society where, soon, one in seven people will be aged over 75.<sup>6</sup>

We now have a significantly larger pensions system, where more people are contributing to their DC pension funds. These DC funds will continually increase in size, as the size of the DB pensions schemes assets under management will eventually decrease over

time, with most DB schemes now closed to new entrants and/or future accrual.

While most new occupational pension schemes are now DC, many DB schemes remain, continuing to support people's retirement income. In addition, the past ten years have presented a real challenge to DB company pension schemes. The combined impact of low interest rates, increased life expectancy and regulatory change, have meant that some schemes have experienced severe funding deficits.

### What is Pension Risk Transfer and why is it relevant?

PRT principally entails the transfer of a company's DB pension scheme's liabilities and risks to a pension or insurance specialist. There are a number of different PRT products, including longevity risk transfer, whereby a Scheme will insure against changes in life expectancy of its members. This report will focus on bulk annuities, which involve the transfer of a company's DB pension scheme's liabilities to a pension or insurance specialist. These specialists have experienced investment and actuarial teams whose objective is to generate long-term stable returns, which in turn are used to pay out the agreed pensions to pension scheme members. These skills, plus economies of scale, have created the PRT model whereby an organisation such as Legal & General takes on responsibility for meeting pension benefits in return for a premium.

6. Future of Ageing Population, Government Office for Science and Foresight

Being able to transfer some or all the risk to another party frees up resources from a corporate balance sheet. This means sponsor companies can focus on the future growth of their organisation, while feeling comfortable in the knowledge that their pension scheme is supported by an organisation with experience and understanding of longevity and investment risk within a strong regulatory framework. This organisation will make sure members receive the income they are expecting in retirement, so that the company’s promise to its former employees is fulfilled.

**A rapidly growing market**

While the PRT sector began relatively small, in recent years it has become an increasingly important market in terms of the number and size of transactions. It was worth £24.2 billion in 2018<sup>7</sup> and 2019<sup>8</sup> broke the record again with over £40 billion transacted.

In addition to the increased activity, the market is also seeing ever-larger transactions – in terms of both value and the number of scheme members – being completed. A number of large deals were completed in 2019, with examples transacted by Legal & General including Rolls-Royce, National Grid and Tate & Lyle. Other PRT providers, such as Rothesay Life and Pension Insurance Corporation (PIC) secured a number of large transactions during 2019.

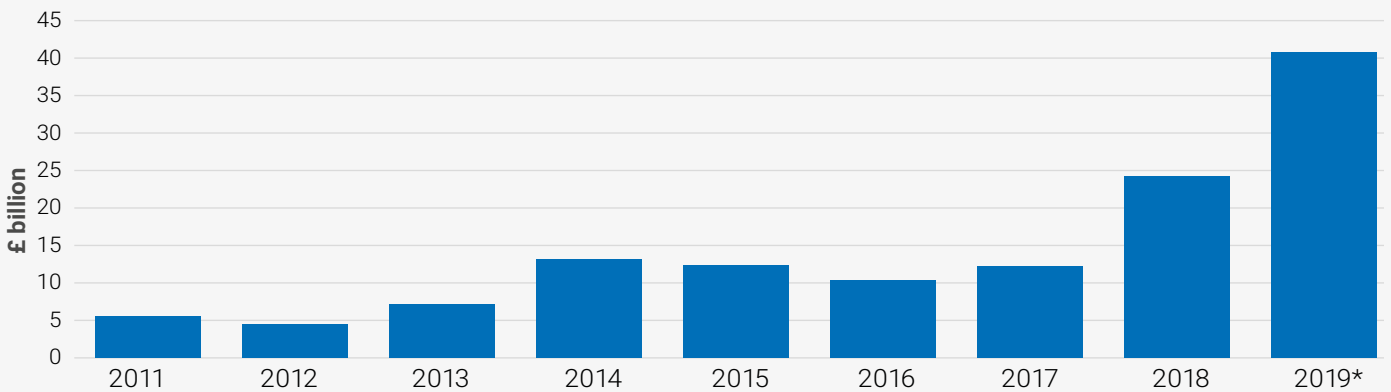
**Ten largest bulk annuity transactions<sup>9</sup>**

Pension scheme	Size £m	Insurer
GEC 1972 Plan (Telent)	4,700	Rothesay Life
Rolls-Royce	4,600	Legal & General
British Airways	4,400	Legal & General
Asda	3,800	Rothesay Life
Allied Domecq (Pernod Ricard)	3,800	Rothesay Life
British American Tobacco	3,400	Pension Insurance Corporation
ICI	3,000	Legal & General
National Grid	2,800	Rothesay Life
TRW	2,500	Legal & General
Philips	2,400	Pension Insurance Corporation

**Smaller schemes**

It is not just large schemes that are being transferred. PRT can also help smaller schemes, which we define as being under £100 million. In many cases, transferring a scheme to another expert party such as an insurer, can secure the investment returns for the pension commitments and prove to be cost effective in terms of administration and other running costs.

**Volumes of bulk annuity business by year**



\*Transactions led by Willis Towers Watson or publicly announced to date  
Source: De-risking Report 2020, Willis Towers Watson

7. Buy-outs, buy-ins and longevity hedging - H2 2018, Hymans Robertson

8. Risk Transfer Report 2020, Hymans Robertson

9. Risk Transfer Report 2020, Hymans Robertson

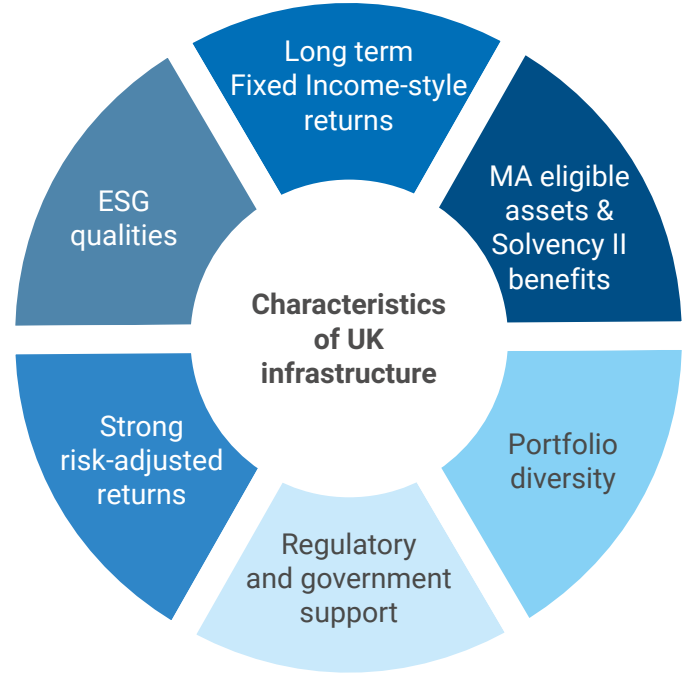


### Connecting pensions to the real economy

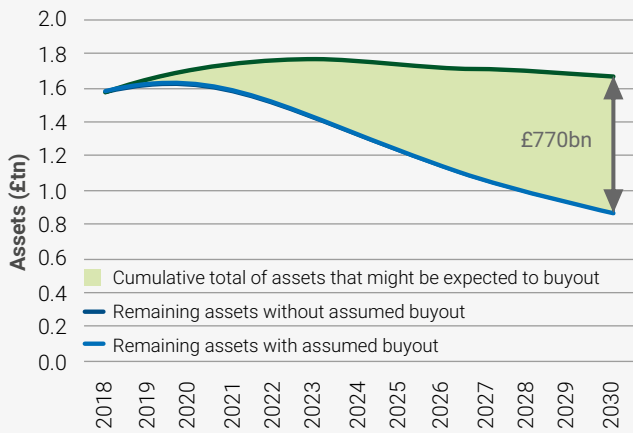
As DB pension funds are de-risked, the premiums paid to insurers can be invested. So too can the underlying assets in DC schemes.

There are investment opportunities all across the UK. Stimulating growth in all regions is a priority of the Government and will be vital for the future economic strength and success of the UK.

UK infrastructure is an asset class that has been the subject of growing levels of institutional investor focus over the past ten years, with market participants such as insurers, pension funds, sovereign wealth funds and others all raising allocations to the sector in order to meet their investment needs.



### The UK PRT market could reach £770 billion over the next decade.

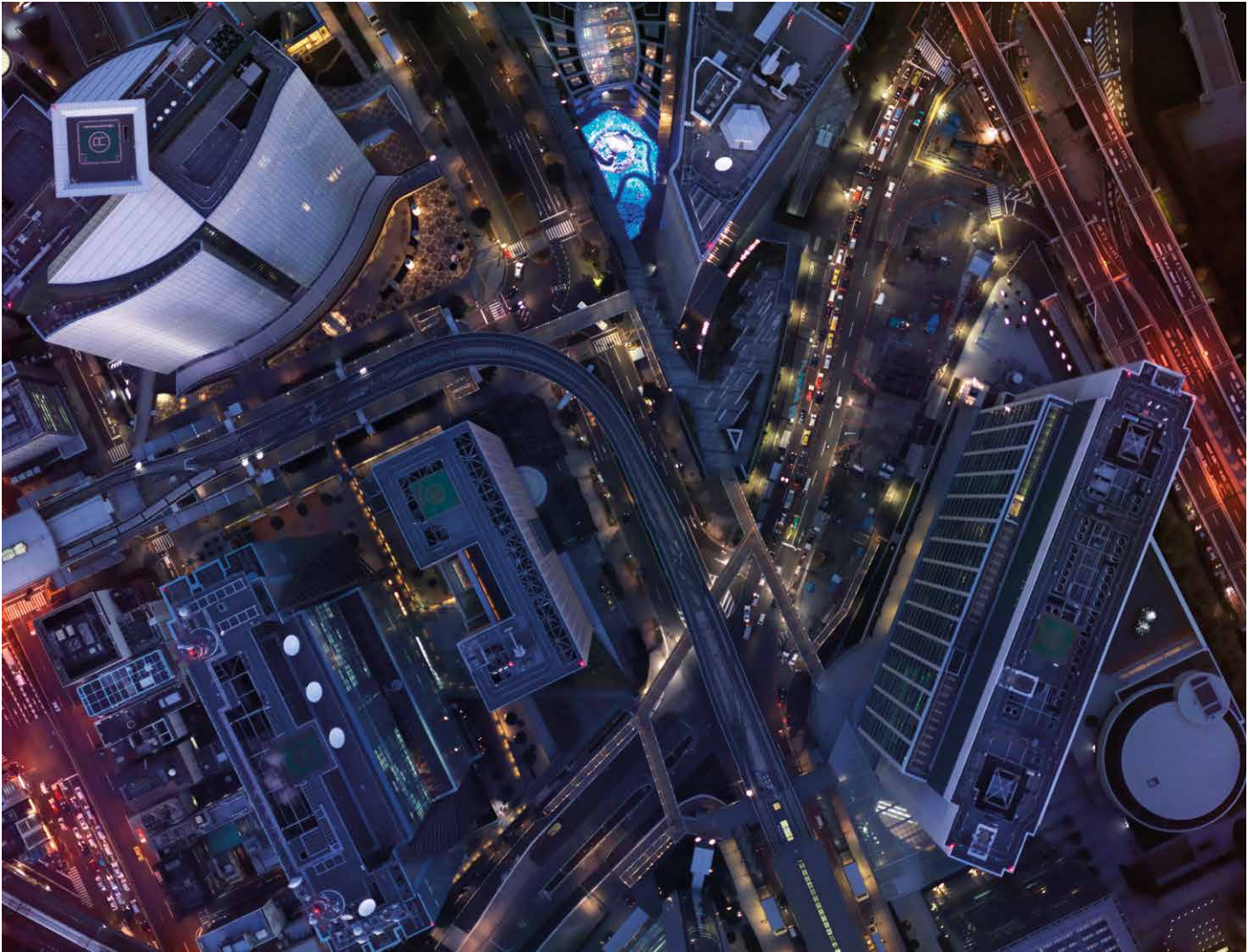


Source: Approaching the endgame: The future of Defined Benefit pension schemes in the UK, Pension Policy Institute

There are many characteristics that make UK infrastructure assets an attractive investment for the PRT market:

- Come in a variety of lengths, type and sizes
- Can offer long-dated, fixed income-style returns
- Can be linked to inflation
- Have potentially higher recovery prospects when compared to unsecured debt
- Can be structured as matching adjustment eligible assets, enabling the PRT market to obtain Solvency II capital benefits
- Typically, less correlated to GDP than other sectors, providing investors with downside protection during periods of macroeconomic recession
- Generally, assets that have contracted or regulated cashflows
- Are consistent with insurers’ commitments to ESG (Environmental, Social, Governance criteria)

# The UK infrastructure challenge



## What is needed?

Our cities of the past must become cities of the future: economically relevant, with infrastructure that matches their global competitors. Infrastructure priorities include the need to retrofit over 20 million old homes to deliver significant reductions in energy consumption and build three million new energy-efficient homes.<sup>10</sup> Public and private transport needs to

be electric and green with vastly reduced diesel and petrol-powered cars and buses.

Making this vision a reality requires the creation of a sizeable, investible pipeline of new infrastructure procurements and investment opportunities.

10. Source: Legal & General's response to Infrastructure Finance Review, 30 May 2019

# Key areas for funding

We believe a number of key areas need urgent funding over this coming decade, including:



## Regeneration and 'Future Cities':

Great regeneration projects can revolutionise urban spaces and create 'Future Cities' by boosting housing supply, backing new infrastructure investment, and creating new, relevant spaces for commercial, retail and public sector use.

As an example, since 2015, Legal & General has partnered with Right Acres, Cardiff Council and the Welsh government and has regenerated an important site in the heart of Cardiff. The £400 million regeneration has delivered a new headquarters for BBC Wales, a new bus station, more than 300 build-to-rent apartments and 100,000 square foot of Grade A office space.

## Urban extensions and garden towns:

The Government has already recognised that the UK's need for new housing cannot be addressed by urban brownfield development alone and has taken steps to encourage the formation of new garden towns and villages, as well as large urban extensions. But these require significant investment. Institutions can fund the upfront infrastructure and receive an income return from resulting plot sales, as well as associated tenure.



## Strategic industrial projects:

Umbrella projects, involving a blend of commercial development and regeneration, need additional attention. Recent examples of these include the ongoing 'Northern Powerhouse' and 'Midlands Engine' policy strategies.

In June 2016, Legal & General became the long-term investment partner of Newcastle City Council and Newcastle University, to build and finance the Newcastle Helix development - a landmark regeneration project and a new major UK hub for scientific research. This is one of the biggest urban regeneration projects of its kind in the UK, creating knowledge-based jobs for future generations in Newcastle and extending the Northern Powerhouse to "the North of the North".

## Affordable housing:

The UK is producing only a third of the affordable homes it needs each year. This restricts where key workers such as nurses and teachers can live, or travel to. Great urban communities need affordable housing as much as they need connecting transport.

Legal & General Affordable Homes was created to lead the evolution of the affordable housing sector. Legal & General Retirement has provided millions of pounds of long-term debt financing to the Group's Affordable Housing business, as it opens the door for UK pension money to back the provision of affordable housing. At the time of writing, Legal & General has a pipeline of over 40 sites across the UK, where it will provide 1,500 affordable homes over the next two years.





**Digital infrastructure:**

Development of digital infrastructure is critical to the future success of the UK economy as it will ensure high-speed connectivity to consumers and businesses. Fibre deployment should be a key priority for the futureproofing of UK digital infrastructure. With fewer than ten per cent of homes covered by full-fibre networks, the UK is materially behind other Western European countries such as Spain and Portugal, where more than 90% of homes have full fibre access. As technology continues to evolve and our future cities become more connected, we see fibre networks and data centres as critical infrastructure of national importance.

**Decarbonisation of transport:**

There have already been a number of commitments made with the intention of reducing our CO2 emissions from the transport system – including the introduction of a future ban on the sale of petrol and diesel cars. But the uptake of Electric Vehicles (EV) is going to be hindered by the fact that there is insufficient supporting charging infrastructure. To install more charge points, EV charging developers, electricity network operators and automobile manufacturers need to work together. In addition, there are a number of other transport networks we should look to decarbonise, including our railway system.

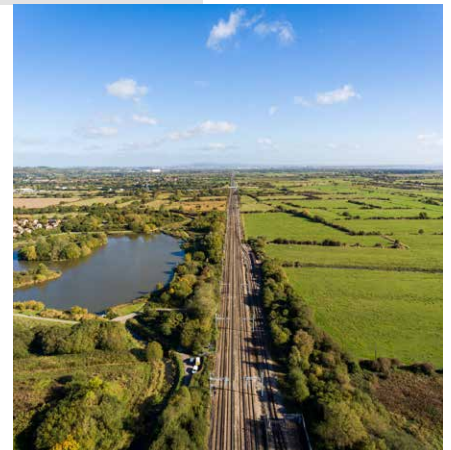


**Clean and green energy:**

The UK is now some way into its renewables journey and new generations of technology are being created, building on the experience and research of the last 20 years. New technologies such as floating offshore wind turbines would benefit from the support that was provided in the early days of fixed-bottom offshore wind. A separate 'Contract for Difference' pot for this technology, which is effectively a guarantee to buy energy for a set price over a period of time, would ensure subsidies for early projects. This could allow the technology to fully develop and costs of build-out to decrease substantially.

**Regional transport/inter-regional connections:**

The regions are calling out for better train, bus and road connections, with too many areas being held back by delayed and cancelled services. Transport infrastructure can influence subsequent employment growth, as the more people can travel into an area, the more growth that area's businesses can support. While COVID-19 may lead to more of us working from home, there will always be benefits to having a well-connected region that supports people in getting from A to B.<sup>11</sup>



11. Future of Ageing Population, Government Office for Science and Foresight

# Closing the UK's infrastructure funding gap



## How much of the gap can pensions fill?

It is clear that pensions and the PRT market have a significant role to play in plugging the £1 trillion infrastructure funding gap.<sup>12</sup> Domestic, sterling-based institutional investors such as insurers and pension funds are providers of long-term, patient capital, which is naturally aligned with the requirements of the UK infrastructure market. As both their liabilities and assets are sterling denominated, they are less concerned than international investors with currency volatility and do not have to incur currency hedging costs.

**We predict pension funds and insurers can invest between £150 billion and £190 billion in infrastructure over the next 10 years.<sup>13</sup>**

12. Source: Internal estimates based on Legal & General data and the contents of the National Infrastructure Plan

13. Source: Source: Prediction by the Legal & General Retirement Investment Solutions team based on current back book allocations, current infrastructure investment volumes and likely sector limits imposed on investors

### How to make this a reality?

The announcement of investments in a range of real assets, such as roads and housing, in the Chancellor's 2020 Spring Budget was a welcome and necessary step in bringing the UK's infrastructure up to a globally competitive standard.

It is a huge task for government to fund and support the hundreds of projects that are needed across the UK, especially during one of the greatest economic shocks in decades, as we come to terms with the effects of COVID-19. We feel that now, more than ever, the pensions sector is perfectly placed to provide the funding to help close the infrastructure gap. We look forward to further detail on these proposed investments to be announced as part of the National Infrastructure Review.

### Suitable projects

Insurers are in a prime position to utilise PRT and their own funds to focus on 'midi-projects' with a large local impact, such as investing to recycle brownfield urban sites and creating intra-regional links.

Projects like these can help UK wealth to spread and encourage growth in all parts of the country, building the Future Cities that we will need in order to compete in the global economy.

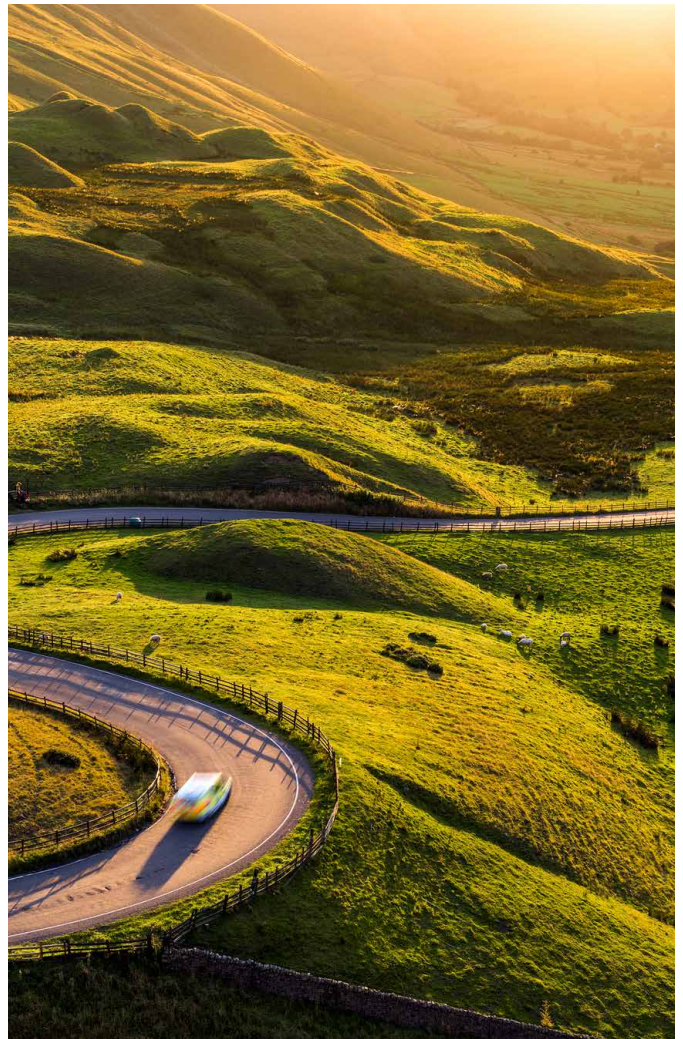
The Chancellor's 2020 Budget announcement in March included proposed investment in a range of projects of different sizes, many of which we would describe as 'midi-projects'. This demonstrates that the Government recognises the value of such investments for regions across the country. We are calling for further constructive collaboration between Government, at both national and local level, and the private sector so that PRT can help plug the infrastructure gap.

### Regulatory stability underpins long-term investment

For such infrastructure investment to be possible, financial regulation must be fair, flexible and globally competitive. Institutional appetite for infrastructure continues to grow, in particular, for investment grade debt financing opportunities. We welcome regulations that make infrastructure an attractive and safe investment and enable the private sector to help deliver key projects.

### Mobilising Patient Capital

To help close the infrastructure funding gap, it is important to mobilise patient (or 'long-term') capital. A system that makes it easier for patient capital to be invested could transform the UK economy and create millions of high paying jobs. The Government has previously considered how best to build the UK's base of patient capital, such as in HM Treasury's 'Financing Growth in innovative firms, one year on'. We want to continue working where we can to unlock further investment in innovative high growth activity, for example through the British Business Bank.



### Future of public-private collaboration

Legal & General wants to expand collaborative partnerships with the public sector to grow the provision of infrastructure assets. The time is right for a new model incorporating even more transparent performance measures which demonstrate the value to investors, public sector and the local communities, with a more holistic overall reference to the impact on people's lives and futures.

### Local and regional support

Regions around the UK are calling out for investment in rail, homes and roads to help bring their infrastructure up to the standard people increasingly expect. The Government, by continuing to develop its work with councils, regional assemblies and mayors, will ensure that local demands for investment are listened to and acted on. In turn, these local government bodies should be encouraged to actively engage with the insurance companies who can partner with them in their Local Development Plans. The focus needs to be on wider geographical investment in the regions outside London, levelling-up the opportunities all across the UK.

## Contact us

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