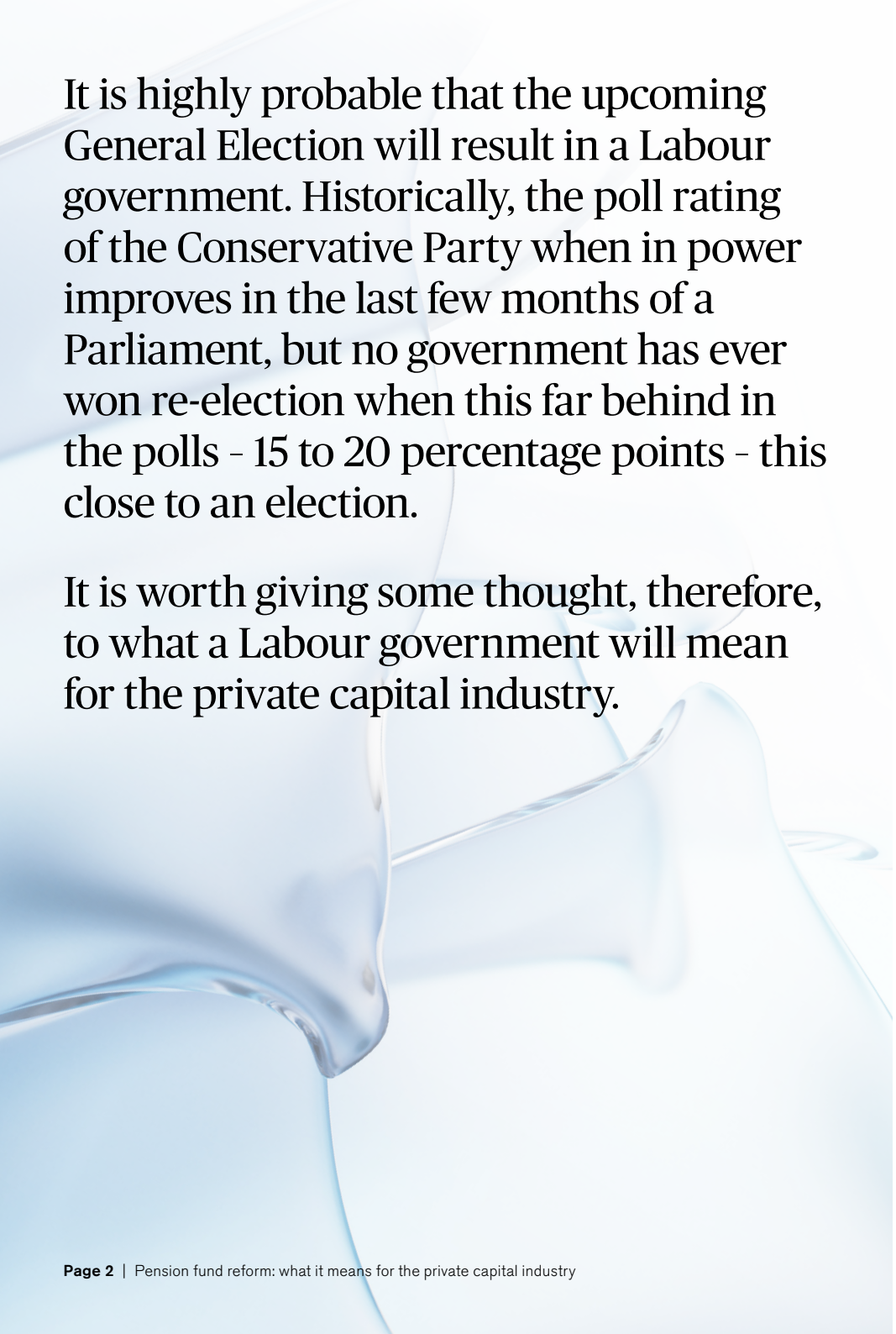


Private Capital Solutions

# Pension fund reform

What it means for the private capital industry

An abstract graphic of a blue liquid splash, possibly water or oil, with a thick, viscous appearance. It starts from the bottom left and moves upwards and to the right, creating a sense of motion and fluidity. The splash is composed of several layers, with the top layer being the most prominent and the bottom layer being more translucent. The overall effect is one of dynamic energy and movement.

It is highly probable that the upcoming General Election will result in a Labour government. Historically, the poll rating of the Conservative Party when in power improves in the last few months of a Parliament, but no government has ever won re-election when this far behind in the polls – 15 to 20 percentage points – this close to an election.

It is worth giving some thought, therefore, to what a Labour government will mean for the private capital industry.

## The growth agenda

It is useful to consider the wider economic and political environment which any Labour government would inherit. The public finances would be in a fragile situation. Government debt is approximately 100% of GDP; debt interest is one of the highest items of government expenditure; public spending projections require substantial cuts in unprotected departments; and taxes are already at the highest level for 70 years. Calls for higher spending may be irresistible, but there is little scope for additional borrowing and higher taxes would be politically challenging.

This situation creates risks and opportunities. Most obviously, a Labour government in need of additional revenue, but mindful of the electoral consequences of squeezing “hard pressed working people”, could pile higher taxes on businesses and the wealthy.

According to Labour itself, however, save for a handful of tax reforms aimed at wealthier taxpayers, that is not the solution. “We cannot tax our way to prosperity”, says Shadow Chancellor, Rachel Reeves, the answer instead, she says, is to deliver higher economic growth. This is where the opportunities arise for private capital, even if – as we discuss below – this may come with strings attached.

Some elements of Labour’s growth plan are of broad application, such as planning reform, an industrial strategy, and a closer relationship with the European Union. Some elements, however, are of particular interest to the private capital industry.

## Unlocking pension fund potential

Most obviously, Labour is keen to divert a greater share of the assets of pension funds into higher risk investments. This is not very different to the agenda set out by the current Chancellor, Jeremy Hunt, in his Mansion House speech in July 2023.<sup>1</sup>

Reeves has promised to review the entire pensions landscape – including private sector defined contribution and defined benefit schemes as well as local authority pensions – to ensure it delivers “full potential” for savers and companies. She is reportedly keen on a “French-style scheme” under which DC funds and the British Business Bank would come together to channel money into UK firms with growth potential. Labour, like the current Government, is wary of mandatory targets on pension funds investing in UK assets but the ambition is clear, pension funds are expected to invest more in growth assets. How that is to be achieved is still to be answered, but there is already momentum to build on and in the wake of Jeremy Hunt’s speech, nine of the UK’s biggest defined contribution scheme providers made the “Mansion House Compact” agreeing to try and allocate 5% of default fund assets (up from 1%) to unlisted equities by 2030 – including for example venture capital and buyout funds.

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<sup>1</sup> Chancellor Jeremy Hunt’s Mansion House speech - [GOV.UK](https://www.gov.uk/government/speeches/chancellor-jeremy-hunt-s-mansion-house-speech) ([www.gov.uk](https://www.gov.uk))

## Case study – France's Tibi programme

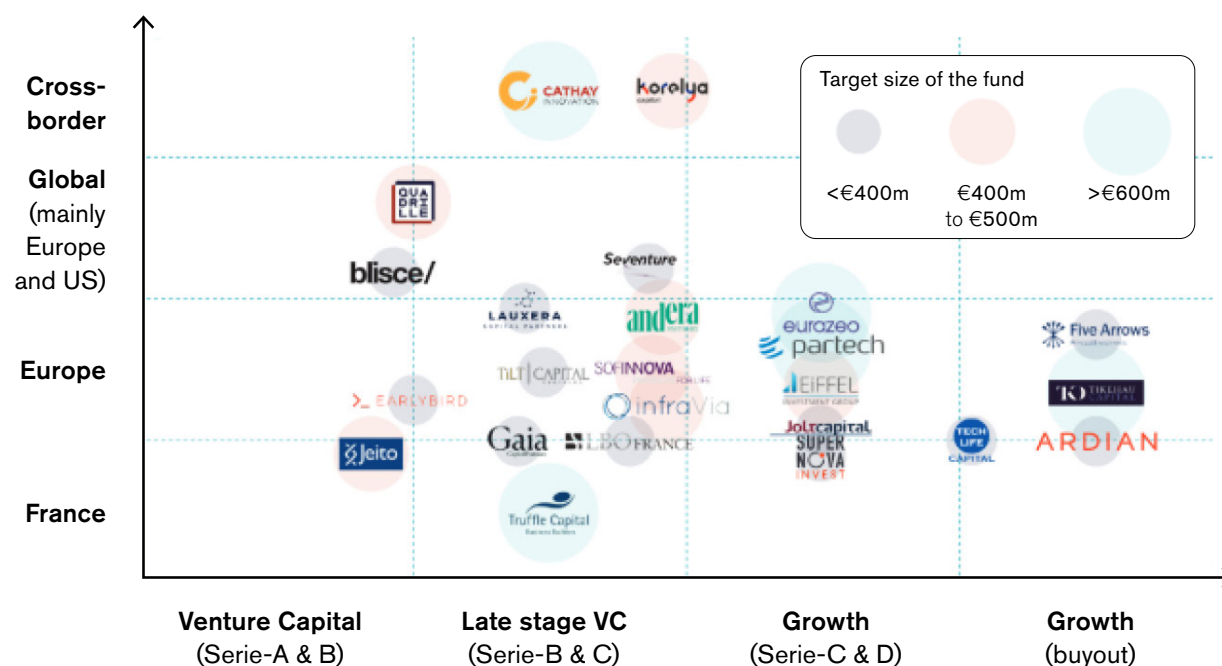
Labour has ambitions to replicate the French Tibi scheme launched in 2019<sup>2</sup>. The scheme's objective is to finance French tech start-ups/scale-ups and make France the leading centre for international investment in technology companies in Europe.

Under this scheme, the Government asked institutional investors (mostly insurers) to pledge a portion of their capital to be invested in French venture capital and buyout funds (both listed and unlisted). To receive the Tibi label, funds must be approved by the Treasury. The approval criteria established that a fund's management company must be primarily established in France and the management team must at least be partly located in France. There is also a preference for French fund structures. The underlying fund strategies must have a French presence but can invest in start-ups outside the country.

The Tibi initiative has been considered a success with over 20 institutional investors pledging to commit €6bn to these funds. In 2023, the initiative was extended, and is to provide an additional €7bn over the next three years. Whilst there is a clear direct benefit for the French asset management industry, the impact on French start-ups/scale-ups is less direct. According to Cedrus and Partners' analysis, only one quarter of the funds with a Tibi label have a strong geographical focus in France, suggesting that a significant portion of this capital may instead be growing European or US companies. If Labour followed this same approach with its own UK scheme, this could allow UK-based managers to benefit from this scheme even if they don't operate UK-centric investment strategies.

### Geographic exposure, investment stage and target fund size of the unlisted funds approved by the Tibi scheme

Source: Cedrus & Partners 2020



The Tibi scheme was not targeted at defined contribution pension schemes (these schemes still make up a small portion of the French pension system) but rather French insurance companies. Whilst several of the insurers that pledged capital to the Tibi scheme do operate their own defined contribution-style funds, there is no indication that commitments would be made on behalf of these funds. Evaluating fiduciary duties has therefore been less relevant for those institutional investors assessing the French Tibi programme, but this will be an important issue for defined contribution pension providers, were a new Labour government to try and introduce a similar scheme here.

<sup>2</sup> (as per Labour's financial services review from January 2024, [Financing-Growth.pdf](#) (labour.org.uk))

## A national wealth fund

Pension fund reform is likely to result in additional funds being diverted towards high growth investment opportunities. Another of Labour's policies may create additional opportunities for those funds investing specifically in the green economy. Labour has set out its intention to establish a National Wealth Fund (NWF), initially announced in the Labour conference in Liverpool in September 2023. Reeves again referred to the plans at the World Economic Forum in Davos this year. The intention is that this NWF will invest alongside the private sector in "gigafactories, clean steel plants, renewable-ready ports, green hydrogen and carbon capture along with supporting service industries, as well as in at least four industrial clusters in Scotland, Wales and England", with every £1 of Government money being leveraged by £3 from private capital.

A NWF is a new departure for the UK and may assist in making certain investment opportunities viable. At this point, it is unclear how exactly it will operate, and sceptics will fear that it will lack independence from government. For example, will its objectives be purely commercial, or will its investment decisions be driven by wider social, environmental, labour relations and even party political (tilting investments towards marginal seats, for example) considerations? This may be unduly cynical but dealing with a potential NWF will be different from dealing with a strictly commercial co-investor.

## Practical impacts on funds and fundraisings

In a tougher fundraising market, fund sponsors will cautiously welcome any further capital provided by a NWF or coaxed out of existing pension fund investors. When quasi-governmental investors interact with private capital, or when asset allocations from pension groups are encouraged by government, this often leads to:

- changes in what investments a private fund makes;
- changes in how a private fund makes its investments; and
- changes in how a private fund sponsor organises itself and its economics.

## Changes to investment policy and strategy

As hinted above, commitments from a new NWF or from enhanced pension fund allocations will likely come with non-commercial requirements.

- Fiscal incentives may be created to ensure that a greater share of pension fund assets is invested in UK private (and public) investments. For a long time, VC funds accepting cornerstone commitments from the European Investment Fund or its associated programmes have had to promise to invest a fixed proportion of the resulting fund in EU SMEs. Similar rules apply where growth capital funds have accepted investment from the British Business Bank. Investment policies may need to promise that a certain proportion of the fund (measured by reference to total fund commitments, invested capital or the capital provided by the NWF or pension fund) is invested in UK investments (although the practical experience of the French Tibi scheme, as discussed above, suggests that selected managers may have more flexibility to invest globally than first imagined).
- Investment policies will need to match up to the mandate requirements of any new NWF. The mooted NWF will focus on industrial projects including those deemed important for energy transition (but outside energy production) and the future industrial landscape. Fund sponsors whose investment policy can encapsulate the favoured and in vogue sectors (or whose investment thesis is squarely focused on growth assets) should be in a better position to secure capital from these new groups.
- Larger pension funds and their trustees have been obliged to consider financially material ESG and climate factors in their investments for some time now, and fund sponsors have already seen this play out in enhanced ESG reporting requirements in side letters. The direction of travel may continue and accelerate if UK pension funds become an instrument of government policy to both increase investment in growth assets and do so in an environmentally responsible manner: ESG requirements may become more central to investment policies.

- There may be more pressure to avoid certain types of investment. In particular, pension fund trustees have been more vocal and active in their use of ESG criteria when picking fund sponsors, and any quasi-governmental investor such as a NWF will typically ask for broad excuse rights or even exit rights from the fund to avoid high-profile investments which might prove "embarrassing" (in the broadest sense) for the Government.

## Holding and making of investments

Fund sponsors may also come under pressure to change the way in which they make, operate and exit, their investments.

- On acquisition and exit, fund sponsors can expect more scrutiny of the nature of the persons they are investing alongside and selling to, as reputational issues become more important.
- NWF and pension fund investors may become more active in trying to impose specific leverage limits. Fund sponsors may be able to manage this, including by offering parallel leveraged and non-leveraged vehicles inside one fund programme, but there is greater difficulty if a NWF imposes limits on leverage used at the level of portfolio companies.
- These sorts of investors would typically prefer plain vanilla holding structures, perhaps steering sponsors to make use of the UK's qualifying asset holding company regime ahead of holding structures which utilise offshore companies.
- A NWF may also have to fulfil its own internal targets and allocations – fund sponsors may find themselves having to report more extensively on matters such as employment figures (and regional activity). This will necessitate processes, reporting systems and controls which are more onerous for smaller portfolio companies to comply with.
- If a NWF has non-commercial objectives, those could clash with fund sponsors who are trying to make portfolio management decisions on pure economic terms. One can easily imagine discussions about restructuring or downsizing a portfolio company (or selling it to a foreign trade buyer as opposed to, e.g. listing in the UK or selling to a UK trade buyer) taking on a different nature if a NWF is a significant and vocal partner in a fund.



## Economics and internal organisation

UK defined contribution pension schemes have operated with a blended fee rate cap of 75 basis points (the “charge cap”), and the conventional wisdom has always been that such schemes will struggle to reconcile the charge cap with the management fee levels charged by private capital funds. However, the reality is that given the preponderance of lower charging passive funds in some of these schemes, trustees may have a bit more wiggle room to allocate to more expensive private fund investments, especially if they can also negotiate headline fee discounts for making earlier and larger commitments to fundraisings. Performance fees have also been excluded from the charge cap since April 2023, which also gives managers more freedom in how they structure compensation. There is undoubtedly still some work to be done by fund sponsors to convince pension fund trustees that private fund investments represent real value on a risk-adjusted and liquidity-adjusted basis, but the Mansion House Compact demonstrates that the larger pension fund providers are coming around to that position.

A NWF will potentially face internal pressures to achieve “value” for the UK taxpayer especially in a tougher fundraising market where it is making an early cornerstone commitment. An easy way to achieve that is obviously to condition larger commitments on fee and carried interest discounts. More interestingly, a NWF may also be obliged to invest only in “structures” which are UK domiciled. This may extend not only to the fund vehicle itself, but to elements of the sponsor structure. Fund sponsors who, for a variety of reasons, operate their business or hold carried interest through offshore entities, may be obliged to simplify these arrangements before their funds accept NWF commitments. Alternatively, bespoke structures may need to be created for NWF investment vehicles separate to the main fund vehicle, with their own carried interest and co-investment entities.

## A new playing field with some new players

Irrespective of the outcome of the next General Election in the UK, the incoming government will face spending decisions and investment requirements which cannot be satisfied out of the public purse alone. The private capital industry should already be thinking about if and how it can adapt to the new priorities investors may have. We expect to see many more conversations in this area, and in particular, a growing interest in running fund programmes through multiple vehicles, which can cater for different investor bases with their own investment policy or economic provisions.

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