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Securing the future of pensions

NAPF Budget 2014 submission: supporting pension funds and pension savers

February 2014

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About the NAPF

The National Association of Pension Funds is the UK's leading voice of workplace pensions. We represent 1,300 pension schemes – defined benefit, defined contribution and hybrid – from all parts of the economy. We also speak for 400 businesses providing essential services to the pensions industry. Our members provide pensions for 16m people and collectively hold assets of around £900bn. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

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Executive Summary

The economic downturn has placed significant pressures on pension schemes and their corporate sponsors. Whilst signs of economic recovery are starting to emerge, fiscal and monetary policies designed to steer the UK out of economic crisis continue to have a lasting impact on pension schemes and pension savers.

As the Bank of England has recognised[1], its Quantitative Easing programme has added to scheme funding pressures, increasing deficits by around £90bn. Whilst the position may have eased somewhat, as yields and long term returns have improved over the last nine months, many schemes have already taken action. Today, just 12% of private sector defined benefit schemes remain open to new members. One third of such schemes are now also closed to future accrual compared to 3% pre-crisis[2]. There is little to suggest that these trends will be reversed unless there is significant additional support from Government.

The introduction of automatic enrolment is a once-in-a-generation opportunity to reverse two decades of pension decline. Early signs are encouraging. Over two million more people are saving in a pension today than were two years ago. In addition, the new single tier state pension will provide a solid foundation on which people can save. However, it is now important that Government – together with the pensions industry – focuses on ensuring savers receive good outcomes at retirement and can save for the long term with confidence.

This Budget is a golden opportunity for Government to support pension schemes and pension savers through a package of measures which, together, will meet the Coalition Government's objective "to help reinvigorate occupational pensions"[3].

The NAPF calls on Government to implement the following measures in a Budget for pensions and pension savers:

1. **The Government to commit to no further tax changes on pension contributions or benefits for the remainder of this Parliament.**
   Over the past two years, the Government has restricted the value of tax relief on pension saving, raising £1bn of extra revenue per year by 2016/17. This not only acts as a disincentive to save in a pension, but also adds considerable complexity and administrative burden to pension schemes. Any further changes would start to seriously adversely impact middle earners and add significantly to the costs of running schemes and cannot be justified.

[1] The Distributional Effects of Asset Purchases, Bank of England, June 2012.
[2] NAPF Annual Survey 2014.
[3] The Coalition: our programme for Government, HMG, 2010.

2. **To help pension schemes match their liabilities, the Government should issue more long-dated and index-linked gilts as part of the DMO's financing remit.**
As pension schemes mature in the face of increased longevity and closure to new members and future accrual, there is a rapidly growing demand for fixed interest assets, especially long-dated and index-linked gilts to help pension schemes match their long, inflation-linked liabilities. A significantly increased supply of long-dated and index-linked gilts would be beneficial to pension funds.

3. **To further support pension funds, the Government and DMO should consider issuing CPI-linked gilts. They should consult with the pensions and insurance industry to determine how a CPI-linked market could be developed.**
Since the Government's decision in June 2010 to allow pension funds to use CPI as a measure of indexation, there has been a growing demand from pension funds for CPI-linked gilts. We believe the time is now right to consider, again, the case for the DMO to issue CPI-linked gilts.

4. **Government should take action to ensure there is a transparent and efficient annuities market, and should support employer-facilitated advice by clarifying the law and providing tax incentives to employers providing 'at retirement' advice to employees.**
With millions retiring from DC pensions over the next few decades it is vital people can access the annuities market easily and be sure it offers fair value. We have welcomed Government interventions to date, but there is more to do. Government must not shy away from intervening to ensure savers receive good value, and should actively help employers to provide guidance to their pension scheme members.

5. **The Government should support future DB provision by introducing legislation at the earliest opportunity that allows scheme sponsors to offer core DB for future accrual.**
Allowing employers greater flexibility in DB scheme design, for example by moving the mandatory requirements to provide certain benefits, could reduce scheme liabilities and improve funding positions. This would be a significant deregulatory measure for Government and, moreover, could encourage those employers currently offering DB schemes to keep those schemes open.

6. **The Government should actively support long-term institutional investors like pension funds access the market for infrastructure.**
There is growing demand by pension funds for infrastructure investment. To support this, the Government should develop a clear pipeline of assets and associated investable instruments suitable for pension funds. In addition, the Government should address current regulatory and fiscal barriers so that the right structures can be put in place to support pension fund investment in infrastructure.

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Priorities for Budget 2014 – supporting pension funds and pension savers

1. Stability in pensions tax

1. Whilst automatic enrolment is proving effective in increasing the numbers of people joining pension schemes, it is important that people contribute adequate amounts and that they remain in their pension schemes, saving for the long term. Tax relief on contributions has an important role to play in encouraging this behaviour.

2. However, over the last two years, pensions tax relief has been significantly eroded. Relief on contributions was restricted to £50,000 a year in 2011 and will be reduced further to £40,000 this year. At the same time, the Lifetime Allowance has been reduced from £1.5m to £1.25m.

3. The Government has argued that these changes only affect top earners. However, their impact is also felt by many middle earners, many of whom will not have very generous pensions in old age. For a worker with 30 years' service in a 60th final salary scheme earning £40,000 a year, a pay rise of around £6,000 in a single year – for example gained through a promotion or job change – would see their relief restricted and could face a significant tax bill.

4. While we support the Government's efforts to manage the deficit, and recognise that a strong economy supports strong pension schemes, we are firmly of the view that there is no further case for tax changes. At a time when Government, industry and the social partners are working together to encourage more pension saving, further changes to the tax system would have a destabilising and disincentive effect both for individual savers and their employers. For example, if the Annual Allowance is further reduced to £30,000 then a pay rise of around £3,000 would send the worker above over the limit. This is even after the 3 year carry over is allowed.

5. Moreover, further change would add considerable complexity and a further administrative burden onto pension schemes, especially DB and hybrid arrangements which are faced with providing complex advice to growing numbers of scheme members. In a recent survey of NAPF member 77% of pension schemes agreed that pensions tax relief administration was an area of concern[4].

[4] The survey was sent to 7,312 members and was open for response from 17-29 January 2014. 108 respondents completed the survey, split approximately two thirds pension scheme fund members and one third business members.

6. We now need a period of stability and certainty for pension schemes and savers and **we call on the Government to commit to introducing no further changes to pensions tax relief for the remainder of this Parliament**.

7. It is not only the tax treatment of contributions to pension schemes that should be supported. So too should the taxation of investments within the funds. We note the HMRC decision, on the basis of the European court ruling last year in the PPG case, to withdraw its long-standing position that 30% of investment management fees can be considered administrative and so recoverable for VAT purposes by the sponsor. For most DB pension schemes and their sponsors this will result in a higher cost burden, both in terms of VAT payable and the bureaucratic burden of determining and proving a split different from the 70/30 presumption. This amounts to the imposition of a stealth tax on the provision of occupational pensions by hard-pressed sponsors, and is a wholly unwelcome step backwards – one that runs contrary to other efforts of Government to support pension provision and sponsors. **We therefore call on the government to review this decision and to reinstate the prior, simple and standardised approach.**

2. A debt financing remit that supports pension saving

8. UK government bonds play a crucial role in asset allocation for the NAPF's members. Long-dated and indexed-linked government paper are a good match for defined benefit (DB) pension liabilities which tend to be linked to inflation, through statutory requirements to revalue and index-link accrued pensions.

9. The increasing maturity of DB pension schemes, coupled with the effects of regulatory action and accounting standards, are pushing schemes to de-risk, thereby increasing pension schemes' demand for long-dated and indexed-linked government bonds. Notwithstanding the expectation of higher bond yields and potentially better longer term returns from equity markets, the maturity of many DB pension schemes means there is little to suggest a reversal in this trend. Over the past five years, DB pension scheme allocations to gilts and fixed income assets have risen from 29% to 45% of total assets[5].

10. We are aware that DMO has previously expressed concerns that an increase in long-dated and index-linked gilts could result in unfulfilled auctions. However, we do not believe this would be the case in practice. We recognise that the issuance of long-dated and long-dated index-linked stock has increased somewhat over the last few years, but it is clear there is still un-met, and growing, demand from pension funds. Pension scheme de-risking and insurance company solvency requirements mean that there will be

[5] 'DB Pensions Universe Risk Profile', Purple Book 2013, TPR/PPF, November 2013.

continued strong demand from pension schemes and insurance companies for these instruments. Like Government and the DMO, NAPF members want an orderly and liquid market in government bonds.

11. **We continue to recommend a further sharp increase in long-term – and particularly long-term indexed – issuance in 2014-2015 to ensure there is sufficient supply of these instruments. Issuance should be executed in reasonably sized auctions and we support the use of syndications. There should be a commitment that the percentage issued in index-linked gilts should, at a minimum, be kept at 25% of overall issuance.**

3. Extending Government support through the gilt market

12. As noted in section 2, there is significant and growing demand from pension funds for index-linked government bonds. This demand is augmented by demand from insurance companies who need index-linked instruments to back their annuity bonds and solvency requirements. The feedback we have from pension funds is that currently they do not have instruments to accurately hedge their liabilities, exposing them to unnecessary and unhelpful risk.

13. Since the Government's decision in June 2010 to allow pension funds to use CPI as a measure of indexation, there has been a growing demand from pension funds for CPI-lined gilts. The latest NAPF Annual Survey[6] suggests that 20% of private sector schemes use some form of CPI indexation for the purposes of indexing pensions in payment and 50% use some form of CPI indexation for the purposes of revaluing deferred pensions. In addition, public sector funds use CPI for both indexation and revaluation, as do some other entitles including the PPF. Given this likely demand, we believe CPI-linked bonds could be issued without undermining the existing gilts market.

14. When the Debt Management Office last considered issuing CPI-linked bonds in 2011 they concluded that there was insufficient clarity on the likely size of the CPI market. As described in paragraph 12 above, we believe this is now much clearer. Furthermore, in November 2011 the DMO also said there was insufficient clarity over inflation indices.

15. **We therefore believe the time is now right to consider, again, the case for the DMO to issue CPI-linked gilts. HM Treasury and DMO should consult with the pensions and insurance industry to determine how a CPI-linked market could be developed.**

[6] NAPF Annual Survey 2013.

4. Delivering good member outcomes

16. Automatic enrolment has already delivered a step change in the nation's retirement prospects and has started to turn around two decades of pension decline. Today, over two million more people are saving in a pension than were saving in a pension in 2012 and opt-out rates are far lower than many predicted. The majority of those who have been automatically enrolled have been placed in a defined contribution (DC) scheme.

17. Having got people to start saving, there is a public policy imperative to ensure people receive good value from their pension scheme. This will be vital in ensuring people have confidence in saving for old age through a pension, that people continue to save, and that opt-out rates remain low. As millions start to draw their pensions over the next few decades, it is essential that they can access the annuities market safe in the knowledge that it operates in a fair and transparent way and that they will be able to convert their pension 'pot' into an annuity that is the right type of annuity for their circumstances and which offers fair value.

18. However, the NAPF is concerned that the annuity market is far from transparent and does not currently operate in savers' best interests. NAPF research in conjunction with the Pensions Institute found that an annual cohort of retirees loses £500m to £1bn in retirement income because they are sold an annuity that does not meet their circumstances – including those that have been sold a single life annuity when they are eligible for an enhanced annuity. These concerns have been echoed by a report from the Financial Services Consumer Panel[7], most recently, the FCA's thematic review of the annuities market which found that 8 in 10 of consumers would be better off if they looked for an annuity in the open market[8].

19. Our research[9] has also shown that advice is important to ensuring people are able to make informed decisions and get a good outcome in retirement. Our research has shown that guidance services are prevalent and mainly fit for purpose. However, it also revealed some significant gaps in the annuity advice market, at both the individual and scheme level. It is clear that not only do individuals with small pots find that the open market is often closed to them because they are uneconomic, but so too do small schemes and scheme with lower paid employees. These groups were also underserved by the advice market.

[7] Financial Services Consumer Panel, *Annuities: Time for regulatory change*. 9 December 2013
[8] Financial Conduct Authority, *Thematic Review of Annuities*. 14 February 2014
[9] NAPF, *Supporting DC savers at retirement: an analysis of the advice and brokerage market.* June 2013

20. The NAPF has welcomed, and actively participated in, the Government's initiatives to improve the operation of the annuities market. But like the Government, we believe that more action must now be taken. The FCA's market review will be an important piece of work in which the NAPF will engage fully.

21. **However, in advance of the outcome of that market review the NAPF believes there are specific actions the Government should take to encourage the provision of scheme and employer-facilitated advice to scheme members:**

    - **First, to broaden the number of schemes and employers providing advice to scheme members/ employees, the Government and regulators should clarify insurer, employer and trustee responsibilities in this area.**
    - **Second, to help small employers and schemes in particular, the Government should urgently review the provisions in the Regulation 5 of Statutory Instruments 2002/ 205 are designed to incentivise workplace facilitated financial advice.**

22. The rules in Regulation 5 currently provide exemptions on employment-related benefit tax to employers offering advice costing up to £150 per employee. However, NAPF research on at-retirement advice shows that holistic regulated financial advice can cost, at a minimum, £500 per person[10]. The NAPF recommends that the Government extends this exemption, giving employers providing their employees with access to pre- and at-retirement advice a rebate on the employment-related benefit tax for this service. Such provision would support employers and schemes in appointing an at-retirement adviser or broker for scheme members.

23. With 400,000 annuities being sold each year[11], the tax exemption could result in employers saving £40m a year on regulated advice that ensures employees get the best annuity. NAPF research shows that, at a minimum, the Government loses an estimated £20m through reduced tax revenues and an increased demand for means tested retirement benefits as a result of the current trends in the sale and purchase of annuities[12]. As pensioners start purchasing better annuities and receiving a higher income, any costs to the Government from this exemption would be expected to be offset by the revenue generated through tax on pension income, increased consumer spending and a lower reliance on means tested benefits from the State.

24. The Government is currently considering bringing a cap on pension charges taken out of pension pots. Discussions with Government officials suggest that the cap would cover all charges incurred by a scheme member. The NAPF supports lower charges for scheme

[10] NAPF, *Supporting DC savers at retirement.* June 2013
[11] Financial Conduct Authority, *Thematic Review of Annuities*. 14 February 2014
[12] NAPF, *Supporting DC savers at retirement.* June 2013

members but believes that this should be considered in the context of the value for money provided to members. **We believe that the Government should consider the impact of a charges cap on default funds where at-retirement services are included in the cap and ensure that this does not cause consumer detriment as a direct result of Government policy.**

5. Enabling flexible pensions provision: Defined Ambition and core DB

25. Pension schemes and their corporate sponsors are under considerable pressure. Over the last five years, the percentage of private sector pension schemes close to new entrants has decreased from 68% to 53%. This has corresponded with a dramatic rise in the numbers of schemes now also closed to future accrual, rising from 3% to 35% over the same period. The consequential growing maturity of schemes, compounded by adverse investment conditions, has impacted scheme funding positions.

26. The new objective for the Pensions Regulator (TPR) to "minimise any adverse impact on the sustainable growth of an employer" will relieve some of the pressure for schemes. We have welcomed its introduction and will work closely with Government (DWP and HMT) to ensure TPR implements its new powers in the way intended.

27. However, we believe that further change is required to support schemes, particularly DB schemes still open to new members and/ or future accrual. In particular, we believe there is scope for Government to make rapid progress with its defined ambition agenda and reforms to DB schemes.

28. The NAPF supports the Government's the Defined Ambition agenda. We agree it is right that scheme sponsors should be given flexibility to provide benefits in a way that is most suited to them and their employees. Rapid progress must now be made to implement elements of the reform package, especially as they relate to DB arrangements. We would wish to see the Government bring forward proposals for 'core DB' arrangements.

29. Within a core DB framework schemes would be permitted to go 'back to basics' and provide benefits which did not include indexation or spouses benefits. Schemes could do so if they wished – and if their funding position allowed – but this would not be a legal requirement (and therefore DB schemes would be put on a level playing field with DC schemes).

30. Allowing greater flexibility over the way benefits from DB schemes are paid would help ease schemes' funding positions. For example, removing indexation requirements and spouse's benefits for a typical defined benefit scheme with 500 members, an accrual rate of 1/60th, and an average pensionable salary of £20,000 a year would reduce costs

by 50%[13]. By containing the liabilities and the costs of providing defined benefits, it is more likely defined benefit schemes still open to new members and/or future accrual will continue to remain open. Any changes to benefit structures should apply to future accrual only and not affect benefits already earned.

31. The introduction of automatic enrolment, which gives almost every working person the right to a workplace pension with an employer contribution, and a higher, simpler, state pension paid equally to women and men and indexed in line with the triple lock, reduces the need for these benefits to be paid from employers' DB schemes. Risks would therefore be shared between the state and individuals as well as individuals and their employer.

32. The introduction of the single tier state pension and the abolition of contracting-out makes the need for reform in this area extremely pressing. With the abolition of contracting out rebates (and, all things being equal, increased National Insurance Rebates for employers and employees), employers will be reviewing their scheme benefit structures. The option to include core DB arrangements at this time would be sensible.

33. **As part of its wider defined ambition agenda, the Government should therefore bring forward legislation at the earliest opportunity that permits schemes to provide greater flexibility in benefit design. This should include provision for core DB arrangements.**

6. Investing in infrastructure

34. Workplace pension schemes have a critical role to play in the success of the Government's pensions reforms. But, as institutional investors, they are also able to provide valuable support to with the wider Government growth agenda, which is focused largely on encouraging long term private sector investment in public infrastructure projects. The Government is looking to institutional investors, such as pension funds to provide that investment. However, infrastructure investment by UK pension funds is currently low compared with overseas pension funds. UK pension funds hold over a trillion pounds in assets, but only around 2% of that is invested in infrastructure. In Canada the aggregate assets invested by pension funds in infrastructure is C$35bn (£22bn) – nearly 4% of total managed assets and in some individual Canadian funds that amount is much higher.

35. In November 2011 the NAPF signed a Memorandum of Understanding (MoU) with HM Treasury and the Pension Protection Fund, committing to work on establishing a

[13] Fit for the Future: Vision for Pensions, NAPF, 2010

platform to facilitate pension fund investment in infrastructure. Since then, we have made considerable progress on developing the Pensions Infrastructure Platform (PIP) and in February its founding investors reached a first close with a fund[14] managed by Dalmore Capital Limited. The PIP's first fund will invest £500 million, predominantly in UK Private Public Partnership (PPP) and Private Finance 2 (PF2) assets. PIP is now considering its wider development and giving attention to other mandates, provisionally in debt and renewables.

36. The PIP is the first undertaking of its kind, a project to establish a fund structure made by pension funds for pension funds, operating truly in the interests of its investors. Its long term aims remain as follows:

    - Target fund size – £2bn.
    - Target return – RPI + 2–5%.
    - Low leverage – no more than 50% across the fund.
    - Low fees – the PIP will operate on a not for profit basis.
    - Lower risk – the PIP will invest at the lower risk end of the infrastructure asset base and avoid GDP risk.
    - Alignment of interests – manager remuneration and incentive structure aligned with pension funds' long term interests.

37. The NAPF has been grateful for the support the Government has shown this project throughout its development. In particular we are grateful to the Department for Communities and Local Government for amending the LGPS Investment Regulations increase the limitation on LGPS funds on investment though limited partnerships from 15%to 30%, which will benefit investment not just in the PIP but investment in infrastructure more broadly. LGPS funds have responded positively, with investment in infrastructure increasing from 0.9% in 2012 to 1.4% in 2013.

38. We were also encouraged by the steps Government took to make Private Finance 2 attractive to pension funds. We urged the Government to think about whether there can be a different entry point in the PFI bidding process for long-term investors such as pension funds, where the commercial basis of the deal has been identified as a suitable investment for pension funds. The new regime should reduce the lengthy, overly bureaucratic, and costly procurement process, for PPP/PFI projects and other government procurement exercises. The equity funding competition, which shortens the procurement process from an investor point-of-view, as well as reducing cost, is a positive step.

[14] PPP Equity PIP LP.

39. But more can be done to make infrastructure attractive and accessible to pension funds. NAPF members have a growing appetite for a broader range of alternative assets as funds seek to de-risk. Infrastructure is one of the most popular, but the amount invested remains relatively low: the total percentage of assets invested is still only 1.4%. Meanwhile, the National Infrastructure Plan 2013 identified a total required investment of over £375bn in UK infrastructure, only 20 per cent of which will be funded by Government. While we recognise the improvement in planning for National Infrastructure Investment that has taken place over the last two years, we are concerned that there is a lack of a visible strategy and marketplace for institutional investors in infrastructure. **It is important that a clear pipeline of suitable assets, associated with transparently and consistently structured investable instruments with appropriate investment characteristics, is made available to long-term investors such as pension funds if institutional investors are to play a greater role in financing infrastructure development.**

40. While the equity funding competition in PF2 is a welcome development, we are concerned that changes are taking a long time to come through: the pilot competition is not expected to be completed until 2015. Pension fund investment in infrastructure will not increase significantly until funds gain more experience and confidence as investors in this space. Therefore it is vital that the Government makes opportunities available quickly.

41. While the UK's stable regulatory environment makes the market very attractive to global investors, development of new entities designed to be aligned with the long-term interests of the underlying investors can be hampered by the current regulatory and fiscal regime.

42. A particular area of concern is the VAT regime in relation to investment management fees. Since 2004, VAT grouping has been denied to outsourcing arrangements and joint ventures. The General Partner (GP) and the Investment Manager of a fund such as the PIP could not be VAT grouped unless they are consolidated in group accounts. This prevents a GP designed to be aligned with the long-term interests of underlying investors appointing an external manager without incurring VAT liability. This would add a cost burden to investors when implementing the fund and corporate structure that would best achieve alignment of interests between investor and investment manager. In the case of the PIP it would therefore work against the aims of the PIP and the original core objective of our Memorandum of Understanding with HM Treasury – to create an efficient investment platform. **We ask the Government to review the VAT treatment of structures such as the PIP.**

43. The implementation of the EU Alternative Investment Fund Managers Directive (AIFMD) is another cause for concern. There is currently a lack of certainty around the process involved for application for Alternative Investment Fund Manager (AIFM) status and the time required to complete that process. **We urge the Government and the FCA to provide investors and fund managers with certainty around implementation of AIFMD.**

44. The UK Government and pensions industry have successfully collaborated in opposing the elements of the review of the Institutions for Occupational Retirement Provision (IORP) Directive and we are grateful for the UK Government's support. We remain concerned, however, that the European Insurance and Occupational Pensions Authority (EIOPA) continues to develop proposals which will have damaging consequences for UK pension funds. We understand EIOPA is preparing to issue five consultations in relation to aspects of the Holistic Balance Sheet in the final quarter of 2014. **The Government has helpfully intervened in the case of Solvency II for insurers in relation to the rating of equity and we urge the Government to continue to support the pensions industry in opposing proposals that would class infrastructure as a high-risk asset and therefore attract significant solvency capital requirements. This would be damaging to the prospects for pension fund investment in infrastructure.**

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Conclusion

45. The Government's pension reform programme – built on auto-enrolment and a single tier state pension – has the opportunity to make a lasting difference to the lives of millions of British citizens by significantly improving their standards of living in retirement. However, there is more the Government must now do to support trustees and scheme sponsors running pension schemes and the people saving in those schemes.

46. The Government should use the Budget in March 2014 to consolidate its reforms and to build on these successes by creating a strong and stable environment for pension provision.

47. The NAPF calls on Government to implement the following measures for a Budget for pensions and pension savers:

    1. **The Government should commit to no further tax changes on pension contributions or benefits for the remainder of this Parliament.**

    2. **To help pension schemes match their liabilities, the Government should issue more long-dated and index-linked gilts as part of the DMO's financing remit.**

    3. **To further support pension funds, the Government and DMO should consider issuing CPI-linked gilts. They should consult with the pensions and insurance industry to determine how a CPI-linked market could be developed.**

    4. **Government should take action to ensure there is a transparent and efficient annuities market, and should support employer-facilitated advice by clarifying the law and providing tax incentives to employers providing 'at retirement' advice to employees.**

    5. **The Government should support future DB provision by bringing forward legislation at the earliest opportunity that allows scheme sponsors to offer core DB for future accrual.**

    6. **The Government should actively support long-term institutional investors like pension funds access the market for infrastructure.**