Interest Rate Dynamics and Institutional Investment in UK Commercial Real Estate

Ioana-Andreea Cristea
Associate, Lucian Blaga University of Sibiu, Romania

Abstract:

This paper examines the relationship between interest rate movements and institutional investment in UK commercial real estate. It focuses on the investment behaviour of pension funds, insurance companies, sovereign wealth funds, and asset managers over a period marked by significant changes in UK monetary policy. The analysis covers the prolonged low interest rate environment between 2014 and 2021, the Bank of England's rapid tightening cycle from December 2021 to August 2023, during which the base rate increased from 0.10% to 5.25%, and the subsequent easing phase from late 2024.

The study is based on conceptual frameworks that integrates Modern Portfolio Theory and Asset-Liability Management to explain how interest rate changes influence institutional portfolio allocation. It argues that institutional investors respond differently to monetary policy because of differences in liability structures, regulatory requirements, investment objectives, and financing constraints. As interest rates rise, higher borrowing costs and stronger returns on fixed-income assets reduce the relative attractiveness of commercial real estate, encouraging institutions to rebalance their portfolios.

The empirical analysis uses annual UK commercial real estate investment volume data for 2014–2025 together with Bank of England base rate data to examine the relationship between interest rates and investment activity using regression analysis. The initial results suggest a negative relationship between higher interest rates and commercial real estate investment. Following the onset of the Bank of England's tightening cycle, annual investment volumes fell by approximately 36%, from a peak of GBP 520 billion in 2021 to GBP 335 billion in 2023, before showing signs of recovery in 2024.The findings also suggest that the effects of monetary policy operate through two related mechanisms: declining asset values associated with capitalisation rate expansion and weaker investment capacity resulting from higher financing costs and tighter debt serviceability constraints.

Overall, the analysis provides initial empirical evidence that institutional commercial real estate investment in the UK is sensitive to changes in interest rates. These findings reinforce the importance of monetary policy in shaping institutional portfolio allocation and investment activity within commercial real estate markets.

Keywords:

Interest rates, institutional investors, commercial real estate, monetary policy, Bank of England, portfolio allocation, asset-liability management, capitalisation rates, leverage.