UK Finance

UK Finance response to Pensions Investment Review: Call for Evidence (phase 1)

September | 2024

Emma Reynolds MP
Pensions Minister

Dear Emma,

UK Finance response to Pensions Investment Review and offer of industry roundtable

Please find enclosed UK Finance's response to the first phase of your Pensions Investment Review.

UK Finance's members are supportive of the government's aim to boost investment in equities, improve outcomes for savers and reinvigorate UK capital markets. We welcome the government's focus on short-term cost versus long-term value for policyholders. This reflects our members' wider ambition to address the imbalance between risk and reward in the UK investment landscape.

The UK has invested significant time and effort into modernising its capital markets. UK Finance welcomes the government's commitment to finalise and implement this ongoing package of reforms.

Pension investment reform should be seen as an important next step of this work, aimed at unlocking more capital for investment into UK companies and markets; attracting companies to list in the UK; and improving returns for UK savers. Well-functioning capital markets are, in turn, a predicate for a successful pension system – growing and retaining UK-based companies will offer more choice and growth for pension funds. The main themes and recommendations in our response are annexed in this letter.

We are grateful for the opportunity to contribute to this important initiative. If you have any immediate questions in relation to our submission, please do not hesitate to get in touch.

Given the short window during which this response has been compiled, the views and positions in the attached represent only a summary of preliminary discussions with UK Finance members. We would therefore be delighted to host a roundtable discussion with you, your officials, and UK Finance members on the Pension Investment Review to delve deeper into the implications and opportunities for UK capital markets.

I look forward to hearing from you.

Conor Lawlor
Managing Director, Capital Markets and Wholesale Policy
UK Finance

Annex: main themes in UK Finance response to Pensions Investment Review

- **Defined Contribution (DC) and Local Government Pension Scheme (LGPS) funds are fundamentally different and need to be considered separately when incentivising investment in UK assets.** The risk in a local government pension fund is carried by the government, and ultimately the taxpayer. The risk in a private pension is carried by the individual member. The government can in principle direct allocations to particular asset classes or with a home bias in ways that a private manager – observing their fiduciary duty to deliver the best outcome for an investor – cannot. For DC funds, incentives will be ineffective where they conflict with this fiduciary duty. Mandation should be avoided. Incentives should be explored.

- **The tax treatment of UK equities should be reviewed against treatment of equities in comparable markets.** There should also be a review of restoring the dividend tax credit for UK pension funds abolished in 1997. This would complement the tax reliefs that operate in other parts of the UK capital markets and extend incentivisation to hold UK assets into the UK pension system in a way that would ultimately benefit UK pensioners.

- **The regulation of value for money frameworks and management fees** should be reviewed and revised to create greater flexibility for managers to charge more where higher net returns can be delivered. This should be targeted at allowing managers more scope to access asset classes such as infrastructure or unlisted equities if they believe that the higher specialist management costs may produce greater returns over time. This regulation should be aligned across both pensions and investment management.

- The new **National Wealth Fund** should be tasked with both convening UK investors around a new broad pipeline of UK infrastructure investments and providing a liquidity backstop or similar form of guarantee to help derisk these projects for pension funds or other UK investors. The role of the National Wealth Fund in de-risking and crowding-in private investment **should also not be limited to green infrastructure alone**, but a wider range of UK productive assets and companies should be considered.

- **Auto-enrolment and private pension holding** should continue to be strongly encouraged, especially for younger UK savers in the accumulation phase of lifetime saving where demand for equities and higher risk/higher return assets is greatest. This should be supported by reform of the current **advice and guidance boundary** to enable these savers to access simple investment advice at a low cost, including on investing in UK assets.

UK Finance response to HM Treasury, Department for Work and Pensions, and Ministry Housing, Communities and Local Government's Pensions Investment Review

We welcome this opportunity to engage with the government's Pension Investment Review. UK Finance's members are supportive of the government's stated aim to boost investment in equities, improve outcomes for savers and reinvigorate UK capital markets.

UK capital markets are essential to the international competitiveness of our economy, supporting individuals and families to build financial security, and driving growth in every sector and every region of the country.

UK Finance members, including banks and related financial services firms, provide pension and investment services, and deploy billions of pounds every year in debt and investment in UK equities, infrastructure and other assets. They facilitate every part of the growth engine represented by UK capital markets.

The UK has invested significant time and effort into modernising its primary and secondary capital markets in recent years. Well-functioning capital markets are the basis for a successful pension system – growing and retaining UK-based companies will offer more choice and growth for pension funds.

Pension reform can play a significant role in unleashing the full power of UK capital markets to deliver national economic growth and secure the long-term financial resilience of the British people. Done correctly, pension investment reform should be seen as the important next step of this work, aimed at unlocking more capital for investment into UK companies and markets; attracting companies to list in the UK; and improving returns for UK savers. Any proposed reform must, however, be carefully considered, and must not conflict with the fiduciary duty of private pension funds to deliver the best outcomes for savers.

We have limited our response **to questions one, two and three under the third section – Investing in the UK**, given its focus on the implications of consolidation, cost versus value and investment in equities within the context of UK capital markets.

Question One: What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?

The current patterns of UK pension fund investment reflect several drivers. These include:

i. **Asset performance.** Over the last decade, UK assets have in many cases been outperformed by their equivalents in the US and in other stronger or faster growing economies. The average annual return between 2010 and 2024 for the FTSE 100 has been 5-6%. The equivalent for the US S&P 500 has been 10-12%[1]. In the global infrastructure market, the deep and established US trend for funding public infrastructure through private investment means that almost half of all private-invested infrastructure assets globally are in the US; more than twice the number in all of Europe, including the UK[2]. Strong growth, a healthy pipeline of growing companies and a flow of investable infrastructure projects accessible to private investors are a precondition for any investor interest in the UK, including UK pension funds.

ii. **Diversification.** Fund managers in the UK and around the world always seek to diversify risk sectorally, geographically and across asset classes. In a well-managed general portfolio, it would not be unreasonable to expect fund managers to hold UK assets (including UK equities) broadly in proportion to the UK's share of global GDP and global GDP growth. The UK's share of global GDP has roughly halved in the last thirty years to around 2.5%.

iii. **Defined Benefit Pension Scheme maturity**. The large pool of UK defined benefit pension schemes established in the second half of the last century are now largely closed and most of their members are close to, or in, retirement. This represents over a third of all private pensions in the UK[3]. This creates a structural incentive for these funds to reduce equity exposure and focus on fixed income assets to preserve accumulated savings and deliver stable income. This incentive has been compounded by prudential regulation. The switch to Defined Contribution schemes, with their younger age profile and greater focus on capital growth could increase demand for UK equities.

[1] Calculated from FTSE and S&P reported returns data
[2] Calculated by Clearbridge using Prequin and Bloomberg
[3] See UK Pensions data from the Office of National Statistics (ONS)

iv. **Cost factors**. Trading UK equities is taxed via Stamp Duty Reserve Tax (SDRT) in a way that buying and selling equities in other markets such as the US is not. Fee caps, and a regulatory focus on short-term management costs for investors rather than net total returns, also encourages pension fund managers to adopt low-cost passive investment strategies such as index-tracking. Whilst investments in asset classes such as private equity or infrastructure may cost more to access, they potentially deliver higher returns over time.

v. Uncertain valuations. Unlisted investments by their very nature have an uncertain value. This makes valuations subjective, and subject to abrupt changes if conditions and views change. Where an unlisted investment does not need to be traded, uncertain value is not a concern. In DC schemes however, unlisted investments are allocated to members where there will be considerable turnover as benefits are drawn or transferred. Coincidentally, unlisted investments are traded almost continuously between members. Given the valuation uncertainty, it is not clear that any material holding in unlisted investments would be in the members' best interests. It is important to keep this potential tension between liquidity demands and more complex assets in mind as we reflect on evolving the composition of UK pension funds.

In summary, the structure of UK pension fund allocations reflects the realities of modern investment management in a global economy, structural features of the UK pension model in transition and a series of policy choices that have been made in the UK.

Question Three: Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?

It is important to recognise that private Defined Contribution (DC) and Local Government Pension Schemes (LGPS) funds are fundamentally different and need to be considered separately in this and other respects. The risk in a local government pension fund is carried by the government, and ultimately the taxpayer. The risk in a private pension is carried by the individual member. Who carries the risk is key to how incentives can and will operate in both cases. The government or local governments can in principle direct allocations to particular asset classes or with a home bias in ways that a private manager observing their fiduciary duty to deliver the best outcome for an investor cannot.

For DC funds, incentives will inevitably be ineffective where they conflict with this fiduciary duty. This is doubly true should they be framed as mandatory requirements, which the government should avoid. They also need to be compatible with the operation of the Consumer Duty, which requires a similar focus on the best outcome for the consumer. This may not be compatible with prescriptive approaches to asset allocation.

A number of possible measures should be considered that could support UK private pension funds – and UK investors in general – in holding UK assets as part of a responsible portfolio allocation strategy:

i. The **tax treatment of UK equities** should be reviewed against treatment in similar markets internationally. There should also be a review of restoring the **dividend tax credit** for UK pension funds abolished in 1997. This would complement the tax reliefs that operate in other parts of the UK capital markets – for example, Venture Capital Trusts and the Enterprise Investment Scheme – and extend incentivisation to hold UK assets into the UK pension system in a way that would ultimately benefit UK pensioners.

ii. The **regulation of value for money frameworks and management fees** should be reviewed and revised to create greater flexibility for managers to charge more where this can deliver higher net returns. This should be targeted

at allowing managers more scope to access asset classes such as infrastructure or unlisted equities if they believe that the higher specialist management costs may produce greater returns over time. This regulation should be aligned across both pensions and investment management.

iii. **UK liquidity and solvency regulation** should be reviewed to ensure there are no unnecessary disincentives for DC schemes and other investors to hold UK equities. Insurance and pension regulation has required larger holdings of liquid and 'safe' assets. This reduces demand for 'riskier' assets such as shares.

iv. The new **National Wealth Fund** should be tasked with both convening UK investors around a new broad pipeline of UK infrastructure investments and providing a liquidity backstop or similar form of guarantee to help derisk these projects for pension funds or other UK investors. This must be coupled with adequate planning reform to ensure much greater simplicity and certainty for large projects. At present the planning system effectively acts as a major source of risk for infrastructure investors. It also needs 'de-risking'. The role of the National Wealth Fund in de-risking and crowding-in private investment should also not be limited to green infrastructure alone, but a wider range of UK productive assets and companies should be considered.

v. **Auto-enrolment and private pension holding** should continue to be strongly encouraged, especially for younger UK savers in the accumulation phase of lifetime saving where demand for equities and higher risk/higher return assets is greatest. This should be supported by reform of the current **advice and guidance boundary** to enable these savers to access simple investment advice at a low cost, including on investing in UK assets.

vi. Initiatives like the **Mansion House Compact** represent a useful model of industry collaboration with government in setting a joint aspiration for targeting investment within the framework of fiduciary duty, and with a parallel commitment to ensuring that regulation supports these aims. Consideration should be given to widening the Mansion House framework to listed UK equities.

vii. Establishing market infrastructure to facilitate trading in unlisted equities and funds could also be explored. The UK can lead the way in enabling DC pensions and other investors to build portfolios in private markets in a risk-managed way.

Fundamentally, the question of pension reform must be seen in the wider context of capital market reform and the creation of an investable pipeline of listed and unlisted UK companies and investable UK infrastructure projects. The demand boost of pension reform must be accompanied by the supply boost of strong capital markets. The government should also ensure that it is sending a consistent signal to retail investors on the value of UK equity investment.

Question Two: What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?

It is important to recognise that while fund consolidation is valuable, it is not necessarily a precursor to investment in UK asset classes. Consolidation will also work differently across the DC and LGPS categories. The emergence over the last decade of a much more consolidated landscape of local government schemes may ultimately make it easier for the government to direct investment strategy in certain ways.

DC fund consolidation could in principle produce economies of scale around the specialist skills required to manage or oversee investments in unlisted equities, infrastructure or other alternative assets. This could be supported by a shift in focus to net investment returns. It may also produce funds with greater 'buying power' in terms of negotiating access to such assets. However, while both may be good for UK savers, they may not in themselves produce greater allocations to UK assets specifically. This will depend above all on the returns available in the UK.

It will be important to ensure that consolidation does not produce funds whose scale disincentivises them to make allocations to smaller UK infrastructure projects or unlisted equity in growth companies. One possible role for a NWF could be in aggregating smaller projects or assets of this type into tranches suitable for larger funds.

It is also important to recognise that even when consolidated, there will be important constraints on the ability of DC pension funds to access some alternative assets, especially assets with a high degree of illiquidity or long-term investments that produce a return only at the end of their lives. Pension funds need to maintain relatively high liquidity and pension-holders generally need to access funds at a defined time in their financial life cycle. The practicalities of adapting this model to these asset classes needs careful planning and design.

Consolidation should be seen as one part of a much wider programme of pension and capital markets reform that must be supported by changes to policy and regulation in a range of areas.

We would be happy to discuss the proposals set out in this response further with HM Treasury, Department of Work and Pensions, and the Ministry of Housing, Communities and Local Government.

About UK Finance

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms across the industry, it seeks to enhance competitiveness, support customers and facilitate innovation. Our primary role is to help our members ensure that the UK retains its position as a global leader in financial services. To do this, we facilitate industry-wide collaboration, provide data and evidence-backed representation with policy makers and regulators, and promote the actions necessary to protect the financial system. UK Finance's operational activity enhances members' own services in situations where collective industry action adds value. Our members include both large and small firms, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks.

The Capital Markets & Wholesale division, led by Conor Lawlor, focuses primarily on policy and regulatory initiatives spanning primary markets, M&A, secondary markets, post trade and liquidity management. Our work in these areas includes bringing technical experts from across our membership together to form new views, drive thought leadership, and develop policy positions relevant to the UK reform agenda. Further information is available at: www.ukfinance.org.uk

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