New Capital Consensus

A better investment system for all

New Capital Consensus Submission to the Pension Schemes Bill Public Bill Committee

About New Capital Consensus:

New Capital Consensus (NCC) is a coalition of not-for-profit, apolitical organisations that have come together to explore how the UK's investment system currently contributes to the country's low productivity, inequality and low levels of investment. We are incubated by the Chatham House Sustainability Accelerator, and our partner organisations include Radix Big Tent, the University of Leeds and the Financial Systems Thinking Innovation Centre (FinSTIC).

Over the past two years, we have worked collaboratively with academia, industry leaders and parliamentarians to identify the systemic reforms required to connect purposeful capital to societal goals, unlocking investment to boost outcomes for savers and society - such as powering up the housing sector to solve issues around housing supply - and meeting the Government's growth targets.

Summary of Evidence

In its current form, the Pensions Schemes Bill (PSB) is missing a crucial opportunity to 'tell a new story' about remaking the UK's ambitions for its investment system. It could represent an opportunity to repair the social contract between UK savers and UK society.

By demonstrating that the Government is carefully managing the nation's savings by redesigning the investment system to better connect UK capital to UK social goals and give savers better individual and collective outcomes over the long-term.

This Omnibus Bill currently misses the opportunity to describe the holistic reforms to the pensions system needed to realise this opportunity.

Other jurisdictions have understood the importance of generating public narrative around legislative change. E.g. Trump's Big Beautiful Bill (BBB); Biden's 'Green New Deal' (Inflation Reduction Act); and the EU's 'Savings & Investment Union' and the PSB must grasp the need to reconnect UK savers with local investment demand as its core mission.

It makes useful strides towards consolidation in the Private DB area and in its Value-for-money proposals but needs to simultaneously address intelligent asset allocation in order to put idle money to work for all regions of the UK economy and to prevent low-risk allocation to passive indexes (like the MSCI Global) that drive UK money overseas.

Whilst we accept that tax as a lever for incentivisation cannot be used in this Bill, the government must consider using fiscal policy to deter trustees from defaulting to type when choosing low-cost over value generation. This Bill could, however, explore in its amendments forms of *disincentive,* through Value for Money reporting from trustees in order to justify allocations to low-cost indexes over value-generating ones that could improve the UK economy.

In the wake of the Great Risk Transfer from institutions to individuals after the shift from DB to DC, New Capital Consensus has found that the open-ended nature of retirement funding (as social care costs come into play for an unknown number of years) is a key social risk for citizens.

As the proposed Pensions Dashboard approaches, a fundamental step is for government to convert the population's *uncertainty* about their lives in retirement into *risk*: *uncertainty* cannot be managed but *risk* can be and the DC system can respond with decumulation advice and products accordingly.

In order to reshape the narrative around this Bill and ensure it does not add to the patchwork nature of the investment system, but improves the wiring of the pension system to support productive investment in the UK economy and provide for beneficiaries' retirements, New Capital Consensus recommends the following:

- **Consolidation**: Include a clause to ensure new superfunds are regulated as pension funds - not as insurance products under Solvency UK.

- **Buyouts/Run-Ons**: Propose amendments to disincentivise the premature 'de-risking' of DB schemes through buyouts - robbing the UK economy of up to 20 years of productive investment.

- **Surplus Funds:** Include a set of robust guardrails (detailed below) so that corporate profit extraction rules are developed in lock-step with superfund vehicle rules.

- **Value for Money:** Introduce into the legislation measures to change behaviour of trustees and consultants who tend to discourage long-term investment to generate value and/or legislate to change policing of VfM framework in order to prevent the trustee industry from reverting to type and encouraging low-cost investment over long-term value by defaulting to passive global indices (like the MSCI Global).

<u>Key Points to Address:</u>

1. **Consolidation**

    a. Importance of scale.

i. Asset Owners need scale for a variety of reasons. Their primary activity is affording and having the competency for the setting of strategic benchmarks and issuing investment mandates. To do this, they need a high level of investment skills and internal investment expertise, enabling them to be good commercial counterparts to fund managers that often comprise large global organisations.

ii. They need to have sufficient buying power to be able to purchase services competitively and to achieve proper diversification whilst generating high-quality investment returns. It is generally accepted that the critical mass for such an organisation would be managing at least £30 billion, and probably closer to £50 bn.

b. Potential ‘straightjacket’ of Solvency UK.

i. Both solvency 2/UK and pension fund accounting drive life insurance and pension funds respectively to invest in ‘matched’ investment strategies, i.e. where assets move in line with liabilities. This incentivises investments in bonds and LDI (in the case of pension funds). This dampens returns and produces systemic risk, i.e. risk caused by current levels of herding behaviour across the entire industry; consolidation into vehicles with more diversified investment strategies would reduce herding and systemic risk.

ii. The same above factors discourages investment in illiquid assets, i.e. primary investment in companies and investment in infrastructure ventures. The inability to mark-to-market (i.e. assess the value of such assets by comparing them against similar instruments available in markets) results in them being treated disadvantageously compared to quoted investments. This discourages direct investments in growth businesses and infrastructure projects. This has a negative knock-on effect on the UK economy as investment is channelled towards quoted shares and bonds and away from direct (ie primary) risk-bearing investment in UK-based businesses and infrastructure.

iii. Superfunds need to be able to invest with the freedom of Foundations and diversify risk over time. They need to be released from the mispricing of risk inherent in mark-to-market based regulation and accounting. For this to happen they need to be regulated as pension funds and without a hard solvency measure. They also need to be able to extract excess profits overtime. **The Bill must be amended, therefore, to require regulators to treat Superfunds as pension schemes with a financial sponsor** instead of a corporate sponsor, and without any hard solvency measures, such as Solvency UK.

c. Competition between Buyout and Superfunds.

i. Insurance companies lobbied hard against the DWP's prior attempt to set up Superfunds, as they felt it would compete with their flow of insurance buyouts. Insurance buyouts are inherently inefficient as they drive the defined benefit pension industry to de-risk investment strategies approximately 20 years too early. At a system level, this reduces the UK productive investment capability as schemes reduce their appetite to invest far too early. As a result investment returns are lower and capital that could be put to productive use is invested less productively.

ii. Permitting life insurance companies to set up Superfunds outside their Solvency UK ring fence would stimulate a market in Superfunds and help to reduce premature investment derisking. They have the skills and expertise to do this, it could stimulate investment and growth assets, they could be incentivised to invest in productive UK investment. A precedent exists for this in UK banking fencing. **The Bill should include a clause that Superfunds set up by insurers have ring fenced capital arrangements (like UK retail banks)** so that failures of the Superfunds do not affect the parent insurer and so the Superfund does not fall under Solvency UK.

2. **Encouraging Productive DB investment**

a. Potential of unlocked productive capital.

i. If pension funds invest in real assets for as long as possible i.e. until the retirement payments fall due, the investment returns generated reduce the cost of pension provision substantially. Productive investment is inherently long-term and illiquid. Pensions investment, being inherently long-term should be a major supporter of productive investment. We have disincentivised this through regulation and accounting that encourages schemes to invest in a limited set of assets that match their liabilities. Restoring the natural ability of the £1.2tr in private DB schemes to invest in productive assets should provide a material boost to the UK economy, especially given that most of the payments under existing pension schemes will not fall due for many years.

ii. If, on the other hand, we guide such pension schemes towards buyout, we risk creating material systemic risk, as all schemes and insurers compete for the same types of assets. We will also force schemes to reduce their investment risk appetites (ie reduce their desire to invest in return seeking assets such as those that support economy and corporate growth) and behave so as to increase the cost of pensions provision; this acts against the economy's interests. Guiding schemes away from buyout would be achieved through consolidation into Superfunds with a 'run-on'objective instead of a buy-out objective.

b. Guardrails.

   i. Superfunds need to be regulated to have conduct, governance and competency requirements similar to insurance companies. They must however be regulated as pension funds with the ability to invest in equity risk which reduces over time and also in illiquid assets.

   ii. Their core skills should be investment, with business models that support running schemes on a self-sufficient basis and investing in real assets for as long as possible.

   iii. Excess profits should be derived through investment activity that permits extraction of profits only as members' benefits are secured. Models that share investment profits with members are to be encouraged. The legislation should require profit extraction only as benefits are secured. The technical detail of this would be captured in regulation.

   iv. The setting up of different types of Superfunds is also to be encouraged, enabling them to innovate retirement solutions, be mutual, commercial or even operate as captive pension funds. We want Superfunds to be diverse so to spread risk and open up the potential for different models attractive for different reasons i.e. to create an open market in offerings to schemes. We want these schemes to be able to innovate and have the potential to offer solutions to members e.g decumulation, products providing conversion of pension pots into income.

3. **Value for Money**

   a. Within the UK investment system and particularly DC products, there are numerous incentives to provide liquidity, to provide low cost investment etc, and almost no incentives to generate returns. VFM should help to rebalance the focus on returns over costs and equity. There is a danger that current proposals set requirements for trustees and scheme providers that are insufficiently strong to change industry behaviours.

   b. Some of these behaviours derive from schemes defaulting to standardised solutions provided by third parties. Defaulting to passive global indices is a prime example.

   c. We would recommend that **there should be a requirement written into the legislation on schemes to justify their investment strategies**, how they set strategic benchmarks and how these are expected to optimise returns, net of costs, to their members. There could be a requirement on schemes to describe strategies rejected and why.

d. There also needs to be some oversight of scheme responses,e.g. through reporting, by a regulated body with the right investment and strategic benchmark setting expertise.