PENSIONS AND LIFETIME SAVINGS ASSOCIATION

POLICY POSITION ON PENSIONS AND GROWTH

OCTOBER 2023

INTRODUCTION

- Since early 2023 there has been considerable discussion by politicians, think tanks and the media on whether and how pension funds can be encouraged to invest more in the UK economy, especially regarding companies with the potential for very high growth, albeit usually also at high risk. In response, the pensions industry has worked hard to identify actions that would result in more investment in the UK. The Pensions and Lifetime Savings Association (PLSA) set out its initial assessment of this issue in June 2023 with our paper, *Pensions and Growth: A paper by the PLSA on supporting pension investment in UK growth*.

- Following the Mansions House speech in July, the Government released a number of proposals in this area, some related to pension scheme consolidation. The PLSA responded to these consultation documents over the summer but we felt it helpful to all those with an interest in this topic to also produce a new high level summary of our policy position which takes account both of our earlier report and the Government consultations of the summer.

- We believe there are six actions that Government can take to encourage greater pension fund investment in UK growth. In all cases it is essential that investments should only be undertaken that meet the needs of scheme members:

  - **Pipeline of Assets**: ensuring there is a stream of high-quality investment assets suitable for pension fund needs. This should involve action by both Government, to foster the right regulatory environment, and entities such as the British Business Bank and private sector fund managers to bring new and innovative products to market.
  - **DB Regulation**: introducing greater flexibility into the funding regime for private sector DB schemes, in particular for open DB schemes and those schemes with longer investment time horizons.
  - **Taxation**: introducing fiscal incentives for pension funds so that investing in UK assets is more attractive than investing in similar assets of other countries.
  - **Consolidation**: prioritising the passage through Parliament of a Bill to place DB superfunds on a statutory footing and carrying forward, in a pragmatic way, its current programme of measures related to DC Master Trusts and the LGPS.
  - **Market for DC Under Automatic Enrolment**: taking a range of actions to encourage more focus on performance and less on cost, for example, the greater use of Value for Money tests and setting the right regulatory regime for advice to employers and schemes.
  - **Raising Pension Contributions**: increasing the flow of assets into DC schemes by raising automatic enrolment contributions from 8% to 12% over the next decade. Most of the increased cost should fall on employers rather than employees so that, by the early 2030s, contributions will be made on a 50/50 basis.

- Further information on these six actions is set out at the end of this short paper.

BACKGROUND

- Pension funds already invest over £1 trillion in the UK economy through ownership of shares, corporate bonds, government bonds and alternative investment assets such as property, unlisted equity and unlisted debt.

- They are open to investing more in UK growth provided the assets have the right risk-return characteristics and offer appropriate diversification of investment risk. When investing pension fund assets, it is essential that the investments meet the needs of pension scheme members who rely on them for their retirement income. This is why we believe that Government should not direct the investment of pension funds.

- Investing in high risk, high return assets which the Government terms “productive finance” is not suitable for all types of pension scheme. Such assets are best suited to DC schemes and open DB schemes (private sector or funded public sector), which have long investment time horizons, rather than to closed DB pension schemes which need investment assets that are not liable to sudden fluctuations in value. Larger schemes, for example, those with more than £25-50 billion of assets have considerable governance capability and find it easier to invest directly, or alongside others, in “productive finance”. However, it is important to remember that such assets can be made accessible to much smaller pension funds via the products offered by the asset management industry, e.g. Long-Term Asset Funds (LTAFs), or by Government initiated entities such as the British Business Bank.

- Today there are around £500 billion of assets in DC pension schemes and it is expected that this will grow to around £1 trillion by 2030. There are also around £300 billion of assets in open private sector DB pension funds and around £340 billion of assets in the open (funded) Local Government Pension Scheme. They will also grow over the coming years. All these pools of assets are ones that could potentially be invested in the kind of high risk, high return assets the Government is keen to encourage.

- These pensions already invest in UK “productive finance” assets to some degree but the quantum of exposure is wide and, in the majority of cases, quite modest due to a range of factors including difficulty in identifying suitable investment opportunities, regulatory requirements, a lack of fiscal incentives, and the relatively low level of workplace pension saving now taking place.

- The industry is already taking action to increase its allocation to “productive finance” assets. In July 2023, nine major pension providers and schemes committed in the Mansion House Compact to invest up to 5% of their assets in unlisted equities by 2030 provided they meet the needs of savers. This is expected to amount to around £50 billion.

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CONSOLIDATION

- Some commentators have suggested that the best way to get more investment by pension funds in UK growth is by consolidating the UK's several thousand pension funds into around five or 10 large funds. In practice, this is extremely hard to do, and in cases where it is possible, would take many years, due to capacity constraints within the industry and as many of these schemes have been set up to serve specific employers and have explicit legal commitments underpinning them. As noted above, such wholesale consolidation is also not necessary to achieve greater investment in UK growth.

- Moreover, consolidation is already happening rapidly in pensions: in DC schemes, although there are still thousands of very small schemes (with less than 12 members), now most assets are already managed by around a dozen insurers offering Group Personal Pensions and by a little over 30 authorised Master Trusts. We expect the number of major schemes and providers to fall to around 20 by 2030. Two of the largest Master Trusts already manage over £25 billion in assets each and a number of schemes have the operational aim, through organic growth or mergers and acquisition, to achieve scale of £100 billion by 2030. A number of the large insurers providing Group Personal Pensions are already operating at this large scale.

- In the case of the funded LGPS, following reforms initiated five years ago, assets previously invested by the almost 90 pension funds in England and Wales are already in the process of being consolidated into just eight large asset pools. Finally, in the case of the 4,500 closed private sector DB schemes, which manage assets of over £1 trillion, a significant proportion of which are aiming to transfer their assets and liabilities to insurers over the next decade which will result in these assets being concentrated in around a dozen insurance companies. There are also a number of pension fund consolidators, such as DB Master Trusts and Superfunds, which are keen to grow and play a substantial role in this market.

- The PLSA supports consolidation where this is in the interests of savers:

    - In **DC schemes**, we have long championed the growing Master Trust sector and support initiatives that will enable it to grow further and faster, for example by increasing the level of automatic enrolment pension contributions and by addressing the problem of small pots. We also support regulatory interventions, such as Value for Money tests, that make it easier for such schemes to put maximum focus on the performance of scheme investments (as well as other factors) rather than only their cost.

    - With regard to **private sector DB schemes**, we support initiatives, such as DB Superfunds and DB Master Trusts, which will bring about the consolidation of the many thousands of DB pension schemes. We also support a vibrant and effective buyout and buy-in market provided by insurers. We do not, however, believe that the best option is for the Government to set up a public sector consolidator, unless there is a clear market failure. If the Government does decide to adopt such an initiative, it is important that it does not interfere with the successful operation of the Pension Protection Fund, the compensation scheme for savers in pension funds which go insolvent without sufficient funds to meet their liabilities.

- In the case of the **Local Government Pension Scheme** (LGPS) we support the current consolidation of assets in England and Wales into eight asset pools where it is in the interests of scheme members and where pools are equipped to provide suitable investment products. However, the transfer of assets will take time in order to ensure they are not invested poorly, and there are a number of key governance and administration issues that must be addressed in order to ensure the LGPS can function properly. Government has an important role to play here in allowing enough time for the orderly transfer of assets and in providing sufficient funding to support work by the LGPS Scheme Advisory Board on the Good Governance project.

- Government has already taken action to encourage both investment in productive finance and consolidation of pension schemes. With regard to DC schemes, they have introduced a Value for Money test which will result in many smaller schemes consolidating into larger ones, they have adopted a more flexible approach to the charge cap on default funds used for automatic enrolment, and they have introduced new reporting requirements on investment in illiquid assets which are often also "productive finance" assets. In the case of DB schemes, the Pensions Regulator already provides guidance on how DB Superfunds should operate and the Government plans to place them on a statutory footing as soon as Parliamentary time allows. We believe this statutory regime to be essential to them acting as successful consolidators. As outlined above, in the case of the Local Government Pension Scheme, the Government has already set in motion the path towards substantial consolidation of assets.

SIX MEASURES TO ENCOURAGE PENSION FUND INVESTMENT IN UK GROWTH

- The PLSA believes the right way to quickly encourage pension funds to invest in UK growth is for the Government to undertake the following reforms:

  - **Pipeline of Assets**: Ensure there is a stream of high-quality investment assets suitable for pension fund needs. The British Business Bank should be given the task of identifying and providing UK productive finance assets that achieve the right risk-return characteristics and low cost needed by pension funds. These should not only include unlisted equities but also other illiquid assets such as unlisted debt and infrastructure. The Government should also support action by the asset management industry in providing suitable Growth Funds or investment vehicles, such as the LTAF. We believe pension funds will be much more likely to invest in UK growth if the Government adopts a strategic and long-term approach to supporting key industries, and key tasks such as the Green Transition to achieve Net Zero by 2050.

  - **DB Regulation**: The funding regulations that apply to DB pension funds should be amended to provide greater flexibility over their investments. In particular, DWP regulations, and the related TPR DB Funding Code should allow open DB pension funds, and closed DB pension funds with long investment time horizons, to take more investment risk where this is appropriate to protecting member benefits. For example, the regulatory regime should allow pension funds to place more reliance on the support of the sponsoring employer, more flexibility over the discount rate used, and not force schemes to reduce the investment risk they take by aiming to achieve the "low dependency" funding level.

- **Taxation:** Fiscal incentives should be introduced that make investing in UK growth more attractive than competing assets. We would like the Chancellor to make the following changes: allow tax free dividends on investment by pension funds in UK companies, and provide additional tax incentives, like the LIFTS initiative, in UK start-ups and companies requiring late-stage growth capital.

- **Consolidation**: The Government should prioritise the passage of a Bill through Parliament to establish a secure and statutory regime which will enable the growth of DB Superfunds. It should also take other action necessary to support the consolidation of assets in DB Master Trusts and with insurers through Buyout and Buy-in contracts. Measures to encourage the consolidation of LGPS (England and Wales) assets into the eight asset pools must only take place where the pools can offer the right investment products and it should be done at a pace that protects the value of the contributions paid in by employers and employees. The Government should continue with its planned programme of action to encourage the consolidation of DC schemes, notably through the use of Value for Money tests.

- **Market for DC Under Automatic Enrolment**: The operation of the market in which employers and trustees select their DC pension funds for automatic enrolment purposes must be reformed so that there is less focus on cost and more on performance. Currently, a mandate can be lost due to a difference in annual charges of only a few fractions of a percentage point. Often, this lower cost is achieved by adopting a simpler, less sophisticated investment strategy. In addition to action already being taken by the Government on introducing a Value for Money test we believe the advice by corporate IFAs and Investment Consultants to employers on pension schemes should focus on net performance rather than cost and be aligned with achieving the long-term interest of savers.

- **Raising Pension Contributions**: The UK must increase the flow of assets into pensions by gradually increasing the level of pension contributions under automatic enrolment from today's 8% of a band of earnings to 12% of all earnings starting in the mid-2020s and finishing in the early 2030s. Today, employers only pay 3% while employees pay 5%; we believe this should be equalised so that each pays 6%. Raising automatic enrolment contributions in this way will provide a deep and lasting pool of investment assets for decades to come.

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ABOUT THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

The Pensions and Lifetime Savings Association (PLSA) is the voice of workplace pensions and savings. We represent pension schemes that together provide a retirement income to more than 30 million savers in the UK and invest more than £1.3 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs, and others who play an influential role in people's financial futures. We aim to help everyone achieve a better income in retirement.