CMIT

The Rt Hon Jeremy Hunt MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

10 March 2023

Dear Chancellor,

The Capital Markets Industry Taskforce ('CMIT') was established in August 2022, in consultation with His Majesty's Government, and welcomed by your predecessor, to help drive the reform of UK capital markets. By bringing together industry leaders from across the UK's ecosystem, from the users of capital to the deployers of capital, its aim is to both make recommendations to Government regarding regulatory change but also importantly to be a vehicle to drive cultural change within the industry where needed.

CMIT has established four workstreams. One of those workstreams is focused on ways to unlock more risk capital which can be deployed by the UK investor community into UK assets to drive growth. Peter Harrison (CEO of Schroders) and Andy Briggs MBE (CEO of Phoenix) are chairing this workstream.

The potential opportunity to be addressed has become increasingly clear and has been gaining public attention over recent months. Since 2000, the amount of risk capital being deployed into UK assets (particularly equities) from the UK's pension schemes and insurers has been diminishing at an alarming rate. In 2000, 39% of all shares listed on the London Stock Exchange were owned by UK pension funds and insurers. By 2020, that number had decreased to only 4%.[1]

This trend towards 'removing risk' can be seen when comparing how UK pension funds are allocating assets relative to those of their overseas peers. UK pension schemes now hold only 27%[2] of their investments in domestic and global equities compared to 50% in the US[3]. By contrast, UK pensions now hold 72% of their investments in fixed income, real estate, and other assets, compared to their peers in the US which hold only 32% in these assets[4].

The result of this has been both poorer returns for UK pensioners at an aggregate level when compared to their overseas peers and, importantly, that UK pensions are not being utilised to

[1] Office for National Statistics
[2] Unlocking Productive Investment, New Financial, March 2023
[3] 2022 Willis Towers Watson pensions asset allocation study
[4] OECD Global Pension Statistics. Other assets include alternative assets such as loans, real estate, hedge funds and PE funds. Equities include collective investment schemes which are assumed to be equity-focussed

drive the growth of the UK economy. In total, UK pension schemes and insurers now deploy between only 5-6%[5] of their total investment into UK companies (both public and private).

As the recent 'A New National Purpose' report highlighted, in 2021 the Canadian Pension Plan invested more in a single UK company (£300m) than the entire UK pensions system invested in private equity and growth capital combined (£190m)[6].

The problem statement is clear and we believe there is a substantial opportunity to deploy more long-term UK pension capital into the growth drivers of the UK economy, delivering better returns for savers and faster growth for the country.

There are two key drivers required to achieve this. First, your positive efforts to reform Solvency II are critical to allowing insurers to deploy more risk capital and one that we wholeheartedly support. This reform is also critical in unlocking Defined Benefit (DB) pension scheme cash, as it increasingly transitions to insurance companies' balance sheets through DB buyouts.

The second is the need for the swift consolidation of pension schemes in the UK, structural incentives for them to then deploy that capital into the UK and a renewed focus on returns rather than simply fees. There are currently more than 5,200[7] DB schemes in the UK managing on average just under £400m each[8][9][10]. The Defined Contribution (DC) landscape is even more fragmented, with close to 27,000 schemes, 25,700 of which are micro schemes of fewer than 12 members. Whilst there has been a growth in authorised master trusts, which combine a greater volume of assets (an average of £2.9bn each), at 36 trusts this is still highly fragmented by international standards[11].

The small size of these schemes hinders their ability to invest in assets which are not easily accessible, such as growth companies (public or private), and to build specialist in-house knowledge in areas such as technology and life sciences which the UK wishes to lead in. This in turn leads to worse outcomes for UK savers as, overall, larger pension funds have generated higher returns for pensioners. The £330 billion Canadian Pension Plan Investment Board's (CPPIB) annualised return for the past ten years (net of its investment costs) was 10.5 per cent and the £39 billion Pension Protection Fund returned 9.2 per cent, compared to just 6.2 per cent for the UK's private-sector DB schemes[12].

We would strongly encourage policies to rapidly accelerate the consolidation of DB and DC Pensions into larger schemes and master trusts which can then develop the sophistication required to assess growth investment opportunities. This is not a new concept, and one actively deployed by pension schemes in Canada and Australia for investments they make in the UK, around the world and domestically. This policy should be targeted at all pension schemes however the Government could catalyse this change quickly via the consolidation of the 86 Local Government Pension Schemes in England and Wales.

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[5] New Financial analysis of data from the ABI, AIC, Bank of England, Investment Association, ONS, Pensions Regulator and Pensions Policy Institute

[6] A New National Purpose: Innovation Can Power the Future of Britain. Authors: Sir Tony Blair and Lord William Hague

[7] Annual report on UK defined benefit and hybrid schemes 2022, The Pensions Regulator

[8] Local government pension scheme funds for England and Wales: 2020 to 2021 (publishing.service.gov.uk)

[9] Annual Report and Accounts of NILGOSC for 2020-21

[10] 6. Pensions - Scottish Local Government Finance Statistics (SLGFS) 2020-21 - gov.scot (www.gov.scot)

[11] DC trust: scheme return data 2022 to 2023 | The Pensions Regulator

[12] New Financial research based on OECD data for December 2009 to December 2019

Crucially, these enlarged pensions then need structurally incentivising to invest in the UK economy to drive growth, jobs, and investments in industries of the future. The recent proposal in 'A New National Purpose' for the pension capital-gains tax exemption to only remain for funds with over £25 billion under management and which allocate 25% of their funds to UK assets provides one way to achieve these goals. However, care must be taken to not punish savers. Whilst the details of this measure or alternative structural incentives would require consultation with industry, and a carefully calibrated phase-in period to ensure best outcomes for consumers, the Government should be explicit in their aim to facilitate consolidation of pension schemes and provide an incentive to invest in the UK economy. Pension funds evaluating UK and overseas investments, when those investments deliver equal returns, would have an incentive to deploy into the UK for the benefit of their policy holders.

There is currently approximately £4.6trn being managed by pension schemes and insurers in the UK. As referenced above, these vehicles currently hold between 5-6% of their investments in UK companies[13]. Increasing this to 25%, an allocation level last seen in the UK in 2007, would result in between £874bn to £920bn being redeployed to support the growth of the UK economy[14]. The trend of overseas governments actively incentivising the deployment of capital into domestic businesses should also be noted, recently in the US via the Inflation Reduction Act and now with the EU's proposal to relax state aid rules for green industries and the creation of a European Sovereignty Fund.

Finally, the gradual change over the past two decades to focus on fees rather than returns for pension holders needs to be addressed. This focus has incentivised UK pension schemes to deploy investments into the cheapest asset classes (fixed income, property and index funds) rather than focussing on the best returns for their policy holders and will need to be addressed if the UK is to successfully redeploy its substantial pools of assets to driving economic growth and delivering returns for policy holders.

Whilst a sovereign wealth fund (or a similar institution) would be helpful in deploying more risk capital, we do not believe it is a substitution for consolidating and redirecting investments through the UK's substantial existing pools of capital.

The fragmentation of UK financial services regulation should also be considered when determining the best way forward to drive better economy-wide outcomes. A consistent approach to this issue across departments will be required, particularly in relation to risk appetite, in order for meaningful change to be made. The ongoing consultation by the Department of Work and Pensions on the DB funding code and the position taken on 'low dependency investment allocations' is an example of this. As drafted, this could have the impact of exacerbating the challenges discussed in this letter by restricting investments in equities even further.

To assist in supporting this agenda, CMIT is working with New Financial to produce a report which highlights many of the topics raised in this letter and looks forward to its publication in the weeks ahead. We will also be engaging with Mary Starks in her newly appointed role leading the review of The Pensions Regulator, Nausicaa Delfas upon assuming the role of CEO at The Pensions Regulator, and the Rt Hon Mel Stride MP as Secretary of State for Work and Pensions.

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[13] Unlocking Productive Investment, New Financial, March 2023

[14] Noting that the 25% requirement would include all UK assets including infrastructure and not solely UK companies

We have welcomed the continued dialogue with His Majesty's Treasury over recent months and look forward to continuing to support the Government in delivering its growth agenda.

Yours sincerely,

Peter Harrison (CEO of Schroders plc) and Andy Briggs (CEO of Phoenix Group Holdings Plc) on behalf of the Capital Markets Industry Taskforce