Future Governance Forum

REBUILDING THE NATION 02

Pension reform that delivers for savers and strengthens the economy

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and JP Spencer

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Executive summary

UK policymakers are taking an increasing interest in how pension capital can be deployed to best effect, helping to grow the economy as a whole as well as supporting the prospects of individual businesses. The Chancellor of the Exchequer, Jeremy Hunt, set out proposals in his Mansion House speech on 10 July 2023[1] and the Labour Opposition has also set out its ideas on how pension capital can be used to promote growth.[2] These ideas are likely to be built on in the coming months, including in the forthcoming Autumn Statement.

Since the payment of pension promises depends on economic growth, and since those saving in the pension system are also citizens with a stake in the nation's wider prosperity, we welcome the focus of both major parties on using pensions to help rebuild the nation's economic capabilities.[3] However, we strongly caution against seeing pension capital as 'free money' for fiscally constrained governments to direct. The success of Defined Contribution (DC) auto-enrolment, in particular, has been built on a clear understanding that these savings belong to the individual: there will be a political backlash if savings are seen to be invested in ways which undermine potential retirement incomes.

Our proposals below set out a progressive direction for pension policy, combining the necessary investment the economy needs with better outcomes for savers. Done well, this should turn what is a vicious circle today - low levels of savings leading to insufficient growth, which becomes a disincentive for further saving - into a virtuous circle tomorrow, in which the available pool of capital invested in pensions grows, rates of return increase and citizens are incentivised to save more for their retirement, adding yet more to the overall pot available for productive investment.

Our analysis builds on that set out in *Rebuilding the Nation 01: Progressive principles for effective investment,* with much more detailed discussion of policy and recommendations on pensions below.

Our key recommendations are grouped under three headings:

Reform of Defined Contribution pensions

Defined Contribution (DC) pensions are the future of pension saving, and so policymakers should be considering now what more they can do to ensure that workers in the UK are putting enough into their DC occupational pensions, and that their collective savings are being invested in the most effective way both for the individual and for the nation.

Recommendation 1: Government should extend the eligibility for employees to be automatically enrolled into DC pension schemes and require higher employer contributions over the long term. This would help to grow the total available supply of capital for investment in productive assets and ensure a decent income for today's workforce in retirement.

1 'Mansion House Reforms to boost typical pension by over £1000 a year', HM Treasury, July 2023

2 'START-UP, SCALE-UP Review', Labour Party, 2023

3 Professor Nicholas Barr, 'Symposium on Reciprocity Across the Lifecycle', as part of the Beveridge 2.0: Redefining the Social Contract programme', LSE, September 2021

Recommendation 2: Government should require DC master trusts (i.e. DC pension schemes that multiple employers take part in) to establish a jointly owned investment vehicle to invest in productive UK-based assets, while taking action to consolidate the DC market over time. To drive scale and fairness, government should only allow schemes above a certain size – and which can demonstrate that they serve the whole market – to consolidate smaller pots. Longer term, national government should explore whether to mandate consolidation of some or all of the smaller end of the DC market, as well as introducing a value for money test.

Recommendation 3: Government should, over time, introduce a target for master trusts to invest a minimum of 5% of their fund in productive UK-based assets. The target should be a voluntary ambition to begin with, but made a mandatory legal requirement once an independent regulatory body has determined that there is an adequate supply of productive assets – investable companies and projects – in the market. Ahead of that mandatory target coming into effect, master trust schemes should be obliged to report on progress towards it.

Recommendation 4: Government should roll out the introduction of opt-out, default retirement products that properly provide for people once they finish working. This should begin with allowing NEST (National Employment Savings Trust) to offer default retirement products, and over time move to an insistence that all master trusts offer them. The default product should combine a low-cost drawdown product for a set period after retirement, with a later-life annuity kicking in after that. Government should consider the introduction of longevity bonds to support a market for insuring these annuities if it does not emerge organically. Pension scheme members would retain the right to opt out of the default scheme in favour of another scheme or complete withdrawal of their pension pot should they wish.

Reform of private sector Defined Benefit pensions

Private sector Defined Benefit (DB) pension schemes are not going to be a significant long-term source of investment finance. Aggregating these DB schemes into superfunds does not on its own change the picture. However, for as long as there is an extant DB market we should consider how the capital within them can be best deployed for both savers and the nation.

Recommendation 5: The government should proceed with plans to make it easier for insurers buying out DB schemes to invest in infrastructure, but beyond that should not seek to make closed DB schemes a source of long-term capital for the country. The government's proposals allow insurance schemes to invest in assets with 'similar cash flow characteristics' to bonds when looking to match liabilities in the closed DB schemes which they have bought out. But bolder reforms to incentivise closed DB schemes to move away from bonds and into other assets would introduce too much risk for scheme members who have been guaranteed a certain level of retirement income.

Recommendation 6: The Pension Protection Fund (PPF) should be able to buy-out smaller closed DB schemes where they can demonstrate they cannot obtain buy-out from insurers in the open market. Once the PPF is no longer required to fund significant payments to members, government should consider putting its residual assets to more productive use; for example, as part of a National Wealth Fund.

Public sector Defined Benefit pensions - and reform of the Local Government Pension Scheme

In terms of funded public sector schemes, the largest DB schemes are part of the Local Government Pension Scheme (LGPS). This is currently organised into 86 schemes, and across eight pools, in England and Wales, which together have assets worth a total of £369bn.

Recommendation 7: LGPS assets should be aggregated into a smaller number of geographically focused pools to achieve economies of scale while retaining a local link. The pools should have autonomy from the local authority sponsors to enable them to implement the agreed investment strategy as effectively as possible.

Conclusion

Recommendation 8: Utilising pension fund capital to help rebuild the nation's economic capability will require consensus over several parliaments if a successful and meaningful re-orientation of UK pension investment is to be achieved. While there remain limits as to how much one government can bind its successors in a democracy, policymakers should think about how to embed these reforms in such a way that they stand the best chance of being delivered over the long term.

Our definition of productive assets

In this report, for clarity, we define 'productive assets' as:

- Infrastructure investment which enhances productivity, in the form of debt and equity since both elements are typically integral to the financing of that infrastructure. Debt is where one institution loans the other funds on condition of repayment to set terms; equity is where a stake is taken in the relevant enterprise giving the owner greater exposure to the potential profits and losses, and greater influence over how the enterprise is run.

- Growth capital for new and growing businesses which helps them expand and become self-sufficient, nationally and internationally. Again, this can comprise both debt and equity since each contributes to that growth and has a role to play.

Chapter one: tapping the progressive power of pensions capital

Introduction

Policymakers in search of additional UK private investment capital are increasingly looking to the pools of capital held by UK pension schemes, whose primary purpose is the provision of current and future incomes in retirement of UK employees.[4] This is understandable as the assets of pensions and lifetime insurance comprise by far the largest form of domestic saving in the UK.[5]

Distinct types of pension scheme

Some reform proposals lump together different types of UK pension schemes, without appreciating their different characteristics. However, to maximise the effectiveness of any reforms to the UK pensions landscape it is vital to understand the complexities within it - notably the differences between Direct Contribution and Direct Benefit schemes and, within the latter, to differentiate between private sector and public sector schemes.

A succession of public regulations, supervisory regimes and decisions by employers have created a DB pensions system that is winding down and necessarily invests with an increasingly short term time horizon. At the same time, participation in DC schemes is rising rapidly and it is clear that these will be the dominant pension schemes of the future.

While there is a longstanding debate about the virtues or otherwise of the decisions that have led to this scenario, when considering future policy proposals it is essential to recognise that the trend is by now irreversible. Reform proposals that ignore this reality may not consider potential unintended consequences for the members of particular types of pension schemes.

In this paper we break down the UK pension landscape into its main differing types - DC, private sector DB, and public sector DB - and tailor our recommended reforms accordingly.

4 'Beyond Boosterism', Resolution Foundation, 2023, p.50; 'Unlocking the capital in capital markets', New Financial, March 2023; 'Unleashing Capital', Policy Exchange, November 2022; 'Investing in the Future: Boosting Savings and Prosperity for the UK', TBI, May 2023; 'A New National Purpose: Innovation Can Power the Future of Britain', TBI, February 2023

5 'Beyond Boosterism', Resolution Foundation, 2023, p.50

Reform proposals underway

During Autumn 2023 the government is consulting on a number of steps it could take to reform the pensions market, which can be grouped into three categories:

1. **Scale:** steps to increase the scale of workplace pension schemes so that it is easier for them as organisations to invest in productive assets.

2. **Asset mix:** steps to encourage open public sector DB schemes to make greater investments in productive assets, following pressure on DC schemes to do the same; and

3. **Regulation:** amending those existing rules which inhibit investment in productive assets.

We think these approaches to scale, asset mix and regulation are welcome. Scale, in particular, brings with it other benefits:

1. Bigger funds and bigger pools of capital have **lower unit costs,** which in turn take less money away from the underlying savers and produce better outcomes.

2. Bigger funds have **higher governance budgets,** meaning they can employ more skilled staff and attract more knowledgeable trustees who can pursue more sophisticated investment strategies. Typically, such strategies will involve more investment in productive assets.

3. Bigger funds have the ability to pursue **greater specialisation** which can enable more effective investment. Some of the largest funds create dedicated, wholly-owned investment managers which further helps to lower costs and improve outcomes, as has happened in Australia, Canada and the Netherlands.[6]

However, government would need to go further on both scale and asset mix if we are to see a genuine step change in how the UK pensions landscape delivers, both for individuals and for the nation. In addition to these supply-side reforms, the government also needs to pay attention to the demand for capital - and adopt reforms to ensure that the UK is generating sufficient profitable opportunities in which these funds can invest. If capital in the

6 Christine A. Brown, 'Is Pension Fund Collaboration Possible and Sustainable? Insights from Australian Experience', 2009; Jacob A. Bikker, Onno W. Steenbeek, and Federico Torracchi, 'The impact of Scale, Complexity, and Service Wuality on the Administrative Costs of Pension Funds: A Cross-Country Comparison', Journal of Risk and Insurance 79 (2), 2012, pp.477-514

system exceeds the supply of profitable investment opportunities in UK productive assets, then we will see three negative outcomes.

First, it will mean lower retirement incomes for employees saving in workplace DC schemes. Second, it could cause a loss of confidence in pension saving, reinforcing the vicious circle. And third, it will put further financial pressure on local government which would need to make up the difference between lower-than-expected returns on investment and the guarantees made to pensioners via their open public sector DB schemes.

Below we set out the different pension structures in the UK, the extent to which they are potential sources of productive finance, and the reforms which we believe will increase the funds available for investing in productive assets while safeguarding the interests of pension savers.

Chapter two: reform of Defined Contribution pensions

Introduction

Defined Contribution (DC) occupational pension schemes are those in which one or both of the employer and employee make a set contribution to the employee's pension pot, which is then invested on the employee's behalf. The employer is not liable for guaranteeing the employee a minimum level of income in retirement. The size of the member's pension pot and consequently their retirement income are wholly determined by rises or falls in the value of the assets in the scheme. Most workplace DC schemes are managed by trustees, and in the absence of an employer guarantee those trustees have a significant responsibility to ensure that investments deliver for their members.

DC pension schemes represent the overwhelming majority of current and future pension contributions. Major providers include the government-backed National Employment Savings Trust (NEST) and the profit-for-member People's Pension. DC pension schemes had assets of £545bn in 2022 and this may grow to £1.3trn by 2030.[7] Within a relatively short period, DC schemes will collectively hold more assets than DB schemes.

One major driver of the growth in DC schemes has been the introduction of auto-enrolment (AE), whereby all workers who meet certain criteria are automatically signed up to an occupational pension scheme without needing to opt in to it. AE currently comprises a 4% contribution of qualifying wages from the employee, 3% from the employer and upfront tax relief from the government.

As things stand, the DC market in the UK is highly fragmented. There are up to 3,000 schemes that could benefit from achieving scale.[8] This should not necessarily be challenging to achieve: the absence of a guarantee backed by an employer actually makes DC schemes easier to consolidate, if the political will is there to make it happen.

DC schemes tend to be 'young', meaning that they have far more members and employers contributing to the funds ('positive cashflow') than they have money being taken out by retiring members ('negative cashflow'). This means that they can act prudently and still have greater scope to invest in high return/higher risk productive assets. This happens in Australia, for example, which has a DC system comparable to that of the UK. Diversifying schemes' assets to include holdings in productive assets of this kind, as well as equity and bonds, is likely to reduce overall asset volatility and could also lead to increasing returns.

UK DC schemes are also 'young' in the sense that they tend to have small investment teams and, in contrast with their major Australian equivalents and the 'Maple 8' Canadian public sector DB schemes, do not typically conduct any direct investment of their own, instead outsourcing it to fund managers.

7 'Stop blaming everything on pension funds', Schroders, March 2023

8 There is a larger universe of 26,000 DC schemes but the bulk of these are not true workplace schemes but micro schemes set up for tax efficiency purposes. See William Wright, 'UK capital markets: a new sense of urgency', New Financial, September 2023, p.12

Automatic enrolment: increasing the amount of money in the pot

Although AE has dramatically increased the number of workers who are contributing to an occupational pension, it is still restricted in scope. The employee's contribution is defined as a percentage of their 'qualifying wages'. As this term suggests, it is not drawn from the full monthly salary.

The current government has previously said that it is committed to ensuring that AE applies as soon as people start earning and from their first job, but this has not yet been implemented. The current AE regime also excludes people earning less than £10,000, and those who earn more than that from a collection of smaller jobs, but where no single employment clears the £10,000 hurdle. These last two restrictions disproportionately impact women.

Even for those who do qualify, combined contributions – between employer, employee and government – of around 8% of a larger qualifying salary are still below what is necessary to generate a recommended replacement income in retirement (the Pension Commission recommends a replacement rate of 70% of salary) even for someone on average wages.[9] The Pension and Lifetime Saving Association (PLSA) estimate that the minimum proportion of salary saved should be 12%.[10]

Recent administrations in the UK have talked about raising the contribution level without specifying how the burden would be shared or when exactly it would be enacted. In the last parliamentary session, the government allowed time for debate on a private member's bill to increase automatic enrolment contributions, without signalling whether this was definitive government policy.[11] This is an issue that needs to be addressed sooner rather than later if we are to grow the total available supply of capital for investment in productive assets and to ensure a decent income for today's workforce in retirement.

There would need to be a long, slow glidepath towards increased employer contributions so that it takes only a relatively small proportion of annual growth and comes after wage increases and during times of overall economic growth. This is how it has been done in Australia, which is heading to employer contributions of 12% based on small annual incremental increases, typically of 0.5 percentage points and paused during recessions.[12]

Recommendation 1: Government should extend the eligibility for employees to be automatically enrolled into DC pension schemes and require higher employer contributions over the long term. This would help to grow the total available supply of capital for investment in productive assets and ensure a decent income for today's workforce in retirement.

9 'A New Pension Settlement for the Twenty-first Century: Report: The Second Report of the Pensions Commission, London', Pensions Commission, TSO, 2005

10 'A Research Report Supplement to Five Steps to Better Pensions:Time for a New Consensus', Pension and Lifetime Savings Association, 2022

11 'Pensions (Extension of Automatic Enrolment) Act 2023' UK Parliament, September 2023

12 We also note that automatic enrolment was introduced in Australia in part as a more attractive way of controlling wage inflation than raising interest rates. A policy of gradual increases means that governments can operate it as an additional macro-economic tool.

Master trusts: increasing scale and investment in productive assets

For the UK's DC landscape to deliver both for the nation and for individual savers, we need to consider those reforms which will increase scale and facilitate schemes' potential to invest in productive assets, and those which provide direction and encourage schemes to invest in productive assets.

The current government has indicated that it is open to looking at both of these areas. It has published consultations on workplace retirement products[13], small pots[14] and value for money.[15] It has also welcomed the 'Mansion House compact', a voluntary non-binding statement by a group of pension providers that they will aim to invest 5% of their assets in unlisted equities (start-ups) globally.[16]

However, we believe that government can and should act much more quickly and decisively in this space.

Scale and consolidation

To begin with, policymakers should consider what the most effective mechanism might be to drive consolidation of a fragmented landscape into fewer, more effective multi-employer DC pension schemes known as 'master trusts'. Master trusts are anticipated to have high growth, positive cashflows and (by necessity) a diversified investment approach. This makes them well suited to contribute to an investment strategy aimed at rebuilding the nation, following the example of Australia's successful DC system.

Government should further seek to level the playing field between those master trusts which serve the whole of the market and those which restrict their offer to firms with higher-paid employees. At present, the former are less competitive because they have to administer large numbers of small unprofitable accounts. This means employees on lower wages are less well served by the market.

Our view is that, as a first step, government should require DC master trusts to set up a jointly owned investment vehicle and contribute a proportion of their assets to it, achieving functional consolidation that stops short of mandatory consolidation for now.

Government should also mandate that a provider can only consolidate small pots of existing pensions if it has already achieved a certain scale and if it can demonstrate that it is a genuine whole of market provider. This 'scale test' could be replaced by the value for money test eventually, once the latter has been designed and implemented.

Recommendation 2: Government should require DC master trusts to establish a jointly owned investment vehicle to invest in productive UK-based assets, while taking action to consolidate the DC market over time. In the short term, master trusts should be subject to a value for money test and required to establish a jointly owned investment vehicle and contribute a proportion of

13 'Helping savers understand their pension choices: supporting individuals at the point of access', Department for Work and Pensions, July 2023

14 'Ending the proliferation of deferred small pots', Department for Work and Pensions, July 2023

15 'Value for Money: A framework on metrics, standards, and disclosures', Department for Work and Pensions, July 2023

16 'Mansion House Compact', The Global City, July 2023

their assets to it. To drive scale and fairness, government should only allow schemes above a certain size – and which can demonstrate that they serve the whole market – to consolidate smaller pots. Longer term, national government should explore whether to mandate consolidation of some or all of the smaller end of the DC market, as well as introducing a value for money test.

Investment in productive assets

Scale alone is not enough to deliver better outcomes for savers and the nation. We also need to look at the asset allocation of pension schemes to see what more can be done to influence the direction of the investments being made. The non-binding 'Mansion House Compact' is not sufficient, for four reasons:

1. The compact refers to unlisted equities generally rather than unlisted UK equities specifically. Without further guidance or intervention, trustees and other decision makers will be under a fiduciary obligation to consider unlisted opportunities around the globe, which is dominated by the US market, and hence flows into UK opportunities are likely to gather only a very small share of the total.

2. It is unclear to what extent the government will carry out the coordination and investment functions that are necessary to create a vibrant investible supply of UK projects in the first place.

3. The non-binding nature of the compact may lead to its ambitions being dropped once political attention is focused elsewhere, as happened to other, similar initiatives.[17]

4. While closing the private equity 'gap' is of merit, there is also a wider and potentially much larger investment challenge relating to the financing of net zero infrastructure and other challenges.[18]

For these reasons, we would recommend moving beyond the Mansion House Compact to an arrangement with more teeth. We believe DC master trust schemes should be subject to a legally binding requirement to invest a certain amount of their funds into productive assets (as we have defined them in this paper) and with a focus on the UK. As well as directing asset allocation, such a mechanism could also encourage the consolidation and scale set out above, as smaller schemes which were unable to resource their investment function appropriately would have to consolidate.

17 In 2011, as part of his National infrastructure Plan, the then Chancellor of the Exchequer George Osborne announced the creation of the Pensions Infrastructure Platform with the aim of raising over £20bn from UK pension funds to pay for national infrastructure projects. By 2015, only £1bn had been raised: https://www.ft.com/content/b47e481e-2307-11e5-bd83-71cb60e8f08c

18 'Rebuilding the Nation: Progressive principles for effective investment' Future Governance Forum, November 2023

We recognise that savers must have confidence that investments are being made in their long term interest. To ensure this, we would recommend phasing in the binding target over time. An independent body, likely the Pensions Regulator, would have to consult with relevant stakeholders, including pension schemes and those who offer investment opportunities, to determine whether there is sufficient depth of potentially profitable investment opportunities in UK productive assets for it to be reasonable to apply the target.

This would mean before any target becomes binding, a transitional process would have been in place for several years, giving the system time to bed in. During that time, trustees of DC master trust schemes should be subject to mandatory reporting requirements under which they must regularly explain their approach to investment in productive assets in the UK, and how they are working towards meeting the forthcoming target. Pension schemes will be incentivised to equip themselves to operate in this new market through a combination of these reporting requirements, their interaction with the independent body's consultation and the knowledge that a binding target is coming.

We do not think our proposals will have a significant impact on the demand for UK government bonds ('gilts'). We would expect gilts to continue to appeal to a range of investors, assuming a responsible fiscal approach by the government of the day and an increase in aggregate savings, as discussed elsewhere in this paper.

This new target would interact in important ways with the recommendation above to require master trust pension schemes to establish a jointly-owned investment vehicle. Without that taking place in parallel, there is a risk that pension fund trustees would be pulled in different directions by their obligation to prioritise their members' interest and the government's demand that they invest a minimum amount in a specific asset class, which includes private equity. At their current levels, private equity fees would reduce the returns to smaller pension schemes. However, a joint investment vehicle would build expertise and reduce fees – which is precisely what happened when Australian workers' pension schemes established a joint investment vehicle and successfully halved costs as a result.[19] In turn, the introduction of a binding target for investment in productive assets requires the DC schemes which do not invest directly themselves the incentive to contribute to the joint investment vehicle.

Recommendation 3: Government should over time introduce a target for master trusts to invest a minimum of 5% of their fund in productive, UK-based assets. The target should be a voluntary ambition to begin with, but made a mandatory legal requirement once an independent regulatory body has determined that there is an adequate supply of productive assets – investable companies and projects – in the market. Ahead of that mandatory target coming into effect, master trust schemes should be obliged to report on progress towards it.

19 Christine A. Brown, 'Is Pension Fund Collaboration Possible and Sustainable? Insights from Australian Experience', 2009

Improving retirement outcomes for those on DC schemes

Two-thirds of people who withdraw money from their DC pension pot are currently withdrawing it entirely from the pension system rather than using it to buy a retirement product.[20] Many are then placing it in low interest bank accounts.[21] This is bad for savers and also removes an enormous amount of capital that could otherwise be invested in productive assets.

It also means that the DC pension system as a whole must currently focus on holding high proportions of liquid assets in anticipation of potential withdrawals rather than making longer-term investments in less liquid, more productive assets that would provide a secure income in retirement.

Much of this flows from placing the burden of decision making on the ordinary saver, who lacks the expertise to navigate the complicated world of pensions. Even fully informed decision makers struggle with the complexities around purchasing retirement products, and studies have shown that most people suffer from a range of behavioural biases that impact on their decisions.[22] Unsurprisingly, most people would prefer a pension scheme which has access to the necessary expertise and is mandated to act to take decisions in their best interest.[23]

The ability to withdraw a pension pot in its entirety was introduced as part of a liberalising set of reforms introduced in 2015 by the then Chancellor George Osborne. We do not think that returning to the previous system, which was focused primarily on annuities, is the right answer for DC savers, but clearly the current system is not working either.

The majority of those people who keep their savings within the pension system opt for a drawdown product. This is a fund which remains invested and from which the saver withdraws regular amounts until the fund is exhausted. The typical drawdown product is set up to expire after 20 years, assuming that the member draws down at a constant rate.

20 'A Research Report Supplement to Five Steps to Better Pensions:Time for a New Consensus', Pension and Lifetime Savings Association, 2022

21 Louise Overton and Chris Q Smith, 'Pension decision-making in the New Retirement Land-scape', University of Birmingham and CHASM, May 2022

22 'New Choice, Big decisions: 5 years on', Slate Street Global Advisors and The People's Pension and Ignition House, January 2021

23 'Defining Ambitions: Shaping reform around public attitude', IPPR, December 2013, p.33

There are three main issues with these products:

1. They are typically designed to last for 20 years, but with changing mortality patterns a significant minority of retirees are going to be retired for longer than 20 years.

2. Research by the Financial Conduct Authority (FCA) indicates that over 40% of savers are actually withdrawing at rates that mean that the product will expire after just 10 years.[24]

3. They can be costly, with charges varying significantly.[25] The price cap on charges which applies to default workplace saving plans does not apply to drawdown products.

The mechanism for saving via a workplace pension scheme (accumulation) is essentially 'inertia-based' – after auto-enrolment, people are locked into the scheme and have to actively take steps to leave after the initial qualifying period is up. We believe a similar approach should be taken for drawing down from a pension scheme in retirement (decumulation). This would allow people to rely on their pension provider to offer a default product which would be the best fit for most members.[26] Members could instead opt to make alternative arrangements if they wished, so the pension freedoms introduced in 2015 would remain.

This default retirement product could combine a low-cost drawdown product with a later-life annuity, which would ensure that members' pension pots would be guaranteed not to run out at a later age. As a result of being bought at a later age, such an annuity would also provide higher incomes for a given amount of capital than one bought at the date of retirement. The default retirement product could also be provided via a collective DC scheme, as is the case in Denmark.[27] This would increase the pool of capital for productive asset investment.

The government is currently consulting on next steps for retirement in workplace schemes. It is considering allowing NEST, which was set up as a public sector provider of automatic enrolment, to offer default retirement products. In addition, the government is considering requiring trustees of all workplace automatic enrolment schemes to either make default retirement products available, or to facilitate access for their members to such products.[28]

24 'Retirement income market data 2021/22', FCA, September 2023

25 'Compare pension drawdown plans and charges', Which?, July 2023

26 'DC Decumulation: Evolving the pensions freedoms', Pensions and Lifetime Savings Associations, October 2020

27 Gregg McClymont, Andy Tarrant and Tim Gosling, 'Towards a New Pensions Settlement: The International Experience', Rowman & Littlefield Publishers, 2019, p.48

28 'Helping savers understand their pension choices: supporting individuals at the point of access', Department for Work and Pensions, July 2023

We think the government would be right to allow NEST to offer default retirement products, for which it has had a blueprint ready since 2015.[29] NEST's entry into the wider market, including for people who have not saved with it, would oblige competitors to respond with their own innovative new products.

We also think that within a reasonable timeframe all DC master trusts should be required to offer default retirement products, and if they cannot they should be compelled to consolidate into a larger scheme which does. One of the merits of this is that it would substantially increase the period over which savers belong to the pension scheme and therefore the timeframe over which matching assets are held. This is another mechanism that would make it far more feasible for large master trusts to hold productive or riskier assets, and another means of turning today's vicious circle of low savings levels and low returns on investments into a virtuous circle by dovetailing the interests of savers with of the interests of those wanting to see more investment in productive assets.[30]

To support the development of these default retirement products, the government should consider incentivising insurers to enable the provision of later life annuities. DC master trusts which want to offer the kind of product we have set out above would need to purchase a wholesale annuity, to insure against the risk that the pension scheme member lives longer, thus taking more in annuities than originally anticipated. However, it is not clear at present that such a market for wholesale annuities exists for DC schemes (certainly compared to the market for DB schemes, which we cover in the next chapter). If that remains the case, the government could offer longevity bonds – in essence, a bond where the regular payments are linked to the survival of an underlying population – to encourage insurers to enter the market.

Recommendation 4: Government should roll out the introduction of opt-out, default retirement products that properly provide for people once they finish working. This should begin with allowing NEST to offer default retirement products, and over time move to an insistence that all master trusts offer them. The default product should combine a low-cost drawdown product for a set period after retirement, with a later-life annuity kicking in after that. Government should consider the introduction of longevity bonds to support a market for insuring these annuities if it does not emerge organically. Pension scheme members would retain the right to opt out of the default scheme in favour of another scheme or complete withdrawal of their pension pot should they wish.

29 'NEST launches its retirement blueprint in response to pension freedoms' NEST, June 2015

30 'UK Capital Markets- a new sense of urgency', New Financial, September 2023

Chapter three: reform of private sector Defined Benefit pensions

Introduction

Defined Benefit (DB) occupational pension schemes are those in which the employee and employer both contribute to the employee's pension pot, but unlike in DC schemes the employee is guaranteed to receive a certain level of income in retirement irrespective of the performance of their investments. The retirement income is guaranteed by the employer, who must make good any shortfall should the pension fund not generate sufficient returns to cover the payments to retired scheme members.

DB schemes are administered by trustees who have an overriding legal duty to put the interests of their members above all others. DB was once a ubiquitous employee benefit but is now mostly a legacy right. It has been replaced by DC pension saving in most employment relations. Private sector DB looks set to be largely extinguished as a pension option over the next 30 years.

However, for now DB schemes across both the public and private sectors still account for the majority of all pension assets in the UK – approximately £1.98tn in total[31] – and so it is important to consider how that capital can be deployed in the best interests of both individual savers and the nation, even if the answer to that question is likely to be different for DB schemes than for the DC schemes we have just been discussing. It is also important that we differentiate between private and public sector schemes, and 'open' and 'closed' schemes, as each has characteristics which will require different policy solutions.

Closed private sector DB schemes

Closed DB schemes are those which are no longer open to new members, and in some cases to new accruals by existing members. They comprise the vast majority of DB schemes: about £1.2tn of the £1.58tn held in private sector DB assets.[32] 62% of closed private sector DB schemes expect to be fully-funded by 2027, i.e. their assets assessed as capable of meeting current and future liabilities to pay pensions to their members.[33] This situation has been driven by the rise in bond yields as interest rates have been raised.

When closed schemes are fully-funded, the trustees of those schemes will typically seek 'buy-out' from an insurance company. A buy-out allows the trustees to obtain the certainty of a guaranteed income for all the members of the scheme from an insurance company. In exchange the insurance company takes the assets of the scheme. The sponsoring company of the scheme may have to pay an additional amount, depending on the value of the assets held by the scheme, to complete the buy-out. The consequence of the buy-out is that risk transfers to the insurance company.

DB schemes in 'run off' are receiving no new contributions but are paying out pensions, typically having a negative cashflow. Such schemes tend to invest in

31 'Options for Defined Benefit Schemes: PLSA response to DWP's call for evidence', PLSA, September 2023, p.4

32 ibid.

33 'Most DB schemes expect to be fully funded by 2027', Professional Pensions, March 2023.

bonds, as other types of assets are deemed too risky – especially given that the Pension Regulator's DB Funding Code encourages (with risk of enforcement) that trustees match assets and liabilities.[34] Insurance schemes which aggregate pension schemes' assets and liabilities via the 'buy-out' process similarly tend to invest in bonds, for the same prudential reason.

There is some limited scope for this to change. The government has tabled secondary legislation to the Financial Services and Markets Act 2023 which would, among other things, allow insurance schemes in the future to remain compliant with the prudential rules if they substitute assets with 'similar cash flow characteristics' to bonds.[35] This seems sensible and would allow insurers to invest in UK infrastructure to a greater extent and still be considered to be matching their liabilities.

However, more sweeping proposals to increase the exposure of closed DB schemes to riskier assets (including through superfunds, as we set out below) introduce too high a degree of risk. This could expose closed DB schemes to private equity assets which could take 10 to 15 years – or considerably longer – to realise their expected value.

The conclusion from this analysis is simple: closed DB schemes are in general not going to be a viable, significant source of long-term capital for the UK economy, even if there are some short term gains to be had from reforming prudential rules, and to a more limited extent via possible changes to the role of the Pension Protection Fund (set out below).

Recommendation 5: The government should proceed with plans to make it easier for insurers buying out DB schemes to invest in infrastructure, but beyond that should not seek to make closed DB schemes a source of long-term capital for the country. The government's proposals allow insurance schemes to invest in assets with 'similar cash flow characteristics' to bonds when looking to match liabilities in the closed DB schemes which they have bought out. But bolder reforms to incentivise closed DB schemes to move away from bonds and into other assets would introduce too much risk for scheme members who have been guaranteed a certain level of retirement income.

DB 'superfunds'

That is not to say that there is no scope for consolidation within the DB sector at all. DB 'superfunds' are collective funds which are intended to take on closed DB schemes from individual employers where the individual scheme does not have sufficient assets to attract buy-out from an insurance scheme now or within the next 5 years.

Going into the superfund severs the link with the employer. Protection instead comes from a possible capital buffer provided by external investors (who expect a return) and a capital injection from the employer. Where investment returns and the funds received as buffers are still insufficient, the superfund has to enter the Pension Protection Fund (see below) and its members could be obliged to take lower incomes in retirement than those promised.

34 'Code 3: Funding defined benefits', The Pension Regulator, 2023

35 'Draft Statutory Instruments: Financial Services and Markets', HMT, June 2023

The niche nature of the business model appears to have made it difficult for superfunds to work, with only one such fund having been authorised so far.[36]

An alternative model whereby the superfund can take solvent DB schemes and not guarantee the members' pensions has not been authorised by the government – due to the potential impact on pension savers and also the undercutting effect it would have on the insurance industry providing buyouts to individual DB schemes.

Our view is that DB superfunds are unlikely to be a significant or long term answer to the investment problem and bring with them considerable risks to savers. They do not place a premium on the value of a guaranteed retirement income to savers or the extent to which many retired couples may be reliant on sharing one core defined benefit income in retirement alongside a range of other far more volatile income streams. Some 9.6 million savers have claims on a future DB pension and removing the security it provides would be unpopular to say the least.[37]

The Pension Protection Fund

The Pension Protection Fund (PPF) is a government fund that takes in closed DB schemes where the employer sponsor is insolvent and as a consequence cannot meet unfunded liabilities in its pension scheme. The PPF charges a variable levy on all solvent DB schemes and also has the ability to vary the payments it makes to individuals. This flexibility allows it to allocate a much higher proportion of its assets to equities and other growth-seeking risky assets.[38] On its current asset base of £40bn it also had a nominal surplus of just over £12bn in 2022-23.[39]

This has raised suggestions that there may be a greater role for the PPF in acting as a superfund in its own right – and the government is currently consulting on such a proposal.[40] The PPF has welcomed this potential role and said that it could become a 'public sector consolidator'.[41] The benefit of this would be to liberate those employers who are unable to access buy-out of closed schemes on the open market, as well as building up assets in the public sector for productive investment.

However, in practice the PPF faces the same constraint as all other DB schemes: the need to match its assets and liabilities. This might not be a problem if the state provided a guarantee, which would make the PPF very attractive to those trustees seeking buy-out so as to act in the interests of their members. However, it would be a major public policy decision with long term repercussions for future public sector liabilities and it would also mean the PPF would face serious capacity constraints. The PPF itself has suggested that it could perhaps focus on 'schemes which have not proved to be attractive to the

36 Patrick Hosking, ''Superfund' Clara-Pensions says the concept will die unless it does a deal', The Times, July 2023

37 'Defined benefit pension schemes', Work and Pensions Select Committee, April 2023

38 'Asset Allocation Chart', Pension Protection Fund, September 2023

39 Samatha Downes, 'PPF reserves rise by £400m', Pension expert, July 2023

40 'Options for Defined Benefit schemes: a call for evidence', Department for Work and Pensions, July 2023

41 ibid.

private market due to scale, or to the unintended consequences of their earlier attempts to de-risk by buying annuities for part of their membership'.[42]

It should also be noted that as a structural solution to insufficient patient capital, the PPF's investment capacity is an inherently time-limited solution as long as its future capital stock is drawn from closed DB schemes which by definition have a finite life.

Given all of the above, we think the realistic role of the PPF is likely to be limited to offering buy-out to small schemes that cannot obtain buy-out from insurers. Over time, there is also the potential to think creatively about how the PPF's residual assets could be deployed more effectively – but not at a time while significant payments still need to be funded for members.

Recommendation 6: The Pension Protection Fund (PPF) should be able to buy out smaller closed DB schemes where they can demonstrate they cannot obtain buy-out from insurers in the open market. Once the PPF is no longer required to fund significant payments to members, government should consider putting its residual assets to more productive use; for example, as part of a National Wealth Fund.

Open private sector DB schemes

Open DB schemes are those that are still open to employees becoming members. This is a category of pension scheme in structural decline. At this point, they hold the remaining £300bn in assets held collectively by private sector DB schemes.[43] Unlike closed DB schemes, and more akin to DC schemes, open DB schemes can and do invest in productive assets.[44]

However, the same logic of scale and consolidation which we have discussed in relation to DC schemes does not apply to open DB schemes. Open private sector DB schemes are tied to individual employers, who are liable for any deficit in the scheme. To consolidate these individual pension funds into a collective DB scheme would make the individual employers responsible for aggregated deficits accumulated by the group of employers as a whole.

For this reason, we do not see open DB schemes as having anything like the same scope as DC schemes to consolidate and achieve the economies of scale which could reduce costs and increase returns on investment for the benefit of both individual savers and the nation.

42 ibid., p.14

43 'Options for Defined Benefit Schemes: PLSA response to DWP's call for evidence', PLSA, September 2023, p.4

44 For example, Railpen holds over 7% of its assets in private markets and is aiming at 10%. 'In Brief: Railpen extends stewardship programme to private markets portfolio', New Private Markets, June 2023

Chapter four: public sector Defined Benefit pensions – and reform of the Local Government Pension Scheme

Introduction

Given the structural issues outlined above, the public sector now dominates the open DB pension landscape. In the public sector, there is a split between 'funded' and 'unfunded' schemes. Funded public sector DB schemes hold over £400bn in DB assets.[45] The unfunded schemes are effectively paid for by national government out of tax revenue as well as the contributions of current members, for example, Civil Service employees.

Some commentators have suggested that these schemes should become funded in order to then target investment in productive assets.[46] We do not think this is tenable – it would create significant fiscal pressure as the government would be paying the liabilities of legacy pensions as well as trying to fund large new pension contributions at the same time. Among other things, it would likely cripple the state's ability to engage in the co-investment often needed in productive assets.

We do not believe that unfunded public sector DB schemes should be a focus for work on increasing productive investment by pension funds.

Reform of the Local Government Pension Scheme (LGPS)

In terms of funded public sector schemes, the largest DB schemes are part of the Local Government Pension Scheme (LGPS). This is currently organised into 86 schemes in England and Wales, which together have assets worth a total of £369bn.[47] There are also 11 LGPS schemes in Scotland which are the responsibility of the Scottish Government.

In England and Wales, some of the investments are partially rationalised into eight pools. The government is consulting on applying pressure to the schemes to enact a set of reforms, consolidating the pools further by 2025.[48] If the schemes do not conduct these reforms before the requisite date, then the government has indicated that it could deploy a statutory power of direction to require them.

The government is aiming to consolidate investments into a more limited number of pools.[49] We think LGPS funds and LGPS pools have the potential – at the right scale – to be key sources of capital and knowledge for their areas,

45 'Options for Defined Benefit Schemes: PLSA response to DWP's call for evidence', PLSA, September 2023, p.4

46 William Wright, 'UK Capital Markets: a new sense of urgency' New Financial, 2023, p.11

47 'Scheme Annual Report 2022', The Local Government Pension Scheme Advisory Board, June 2023

48 'Local Government Pension Scheme (England and Wales): Next Steps on investments', Department for Levelling Up, Housing and Communities, July 2023

49 ibid., para.14

as seen in South Yorkshire and Greater Manchester.[50] For example, the GreaterManchester Pension Fund has become the first LGPS to invest into such a scheme focused on property, science and technology – while on a UK wide basis it also happens to have a large footprint within the Greater Manchester area.

Giving the pools operational freedom would allow speedier decision making on investments, matching international best practice. Greater pooling should also deliver investment at significantly lower cost, as set out above in relation to consolidation in the DC sector, which in turn would ease the costs of pensions for local government. It may also increase the returns on investment with similar effects. The pools are likely to have greater capacity to invest in productive assets to the benefit of the economy. The proposed targets for start ups and levelling up could potentially incentivise them to do so.

One option would be to centralise the LGPS pools into a single scheme – achieving high levels of operational efficiency and providing the UK with a large fund to rival those seen internationally.[51] However, this would be a significant upheaval for local government and would also remove the link to local areas identified as a key benefit. Another potential option which balances these issues is to **create a smaller number of regional LGPS pools with power of investment** – recognising the need for local institutions and also achieving greater economies of scale (including the potential for administrative efficiencies too). It could be appropriate to link the geographic scale of the LGPS pools to the geographic scale of any regional public financial institutions created, in order to achieve institutional benefits of having shared geographies and to leverage the potential for deploying shared investment vehicles. Further reform or aggregation of LGPS could be considered if this reform does not achieve the stated aims of increasing productive investment.

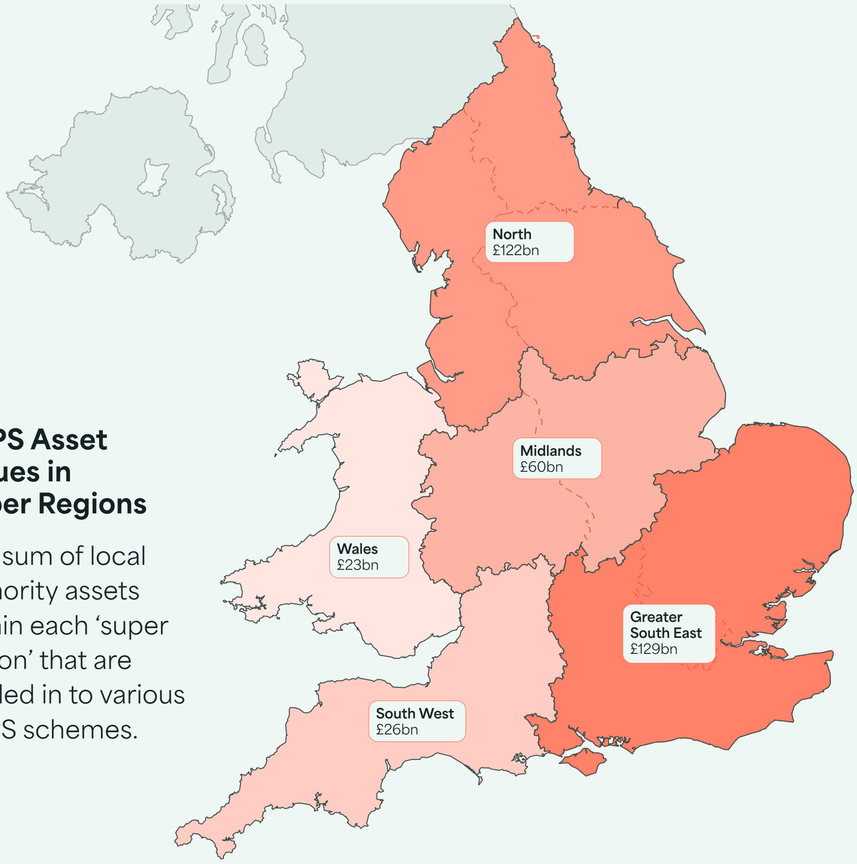
50 'An Independent Assessment of the Place-based impact of Greater Manchester Pension funds local investment portfolios', The Good Economy, September 2023; 'Local Government - Levelling Up', Pension Fund Service, September 2023; 'Legal & General, Bruntwood and Greater Manchester Pension Fund invest half a billion into the UK's science, tech & innovation economy', Legal & General, October 2023

51 'Investing in the Future: Boosting Savings and Prosperity for the UK', TBI, May 2023

Figure 1. Local Government Pension Scheme value by broad region

LGPS Asset Values in Super Regions

The sum of local authority assets within each 'super region' that are pooled in to various LGPS schemes.



Source: Future Governance Forum analysis of LGPS advisory board data (2022)

Recommendation 7: LGPS assets should be aggregated into a smaller number of geographically focused pools to achieve economies of scale while retaining a local link. The pools should have autonomy from the local authority sponsors to enable them to implement the agreed investment strategy as effectively as possible.

In terms of asset allocations for LGPS, we note that the government encouraged private sector DC providers participating in the Mansion House Compact to commit to allocating 5% of their assets to unlisted equities – this would seem a prudent allocation. However, the LGPS is being pushed to allocate 10% to private equity and 5% into currently undefined 'levelling up assets'. Scoping of the risks or the effect on already under-resourced local authorities does not seem to have been undertaken. Nor, oddly, do government proposals stipulate that the investment must take place in the UK.[52]

52 'Local Government Pension Scheme (England and Wales): Next Steps on investments', Department for Levelling Up, Housing and Communities, July 2023, para.82

Conclusion

As we set out in *Rebuilding the Nation 01: Progressive principles for effective investment,* the UK is suffering from chronic under-investment from both the private and public sectors. Given pension and related insurance savings represent the largest pool of existing capital, it is natural for policymakers to look at how that pool might be harnessed to tackle this under-investment. In doing so, there is the potential to create a virtuous circle where the available pool of capital invested in pensions grows, rates of return increase and citizens are incentivised to save more for their retirement, adding yet more to the overall pot available for productive investment. However it is essential in so doing to recognise:

- These assets are not in some sense 'free money' but represent the savings and future livelihoods of the workers and pensioners to whom they belong.
- The distinct nature of the different type of pensions that exist in the UK today.
- The historic and current forces that have driven and continue to drive how those pensions are invested.

We believe the proposals in this paper represent a practical way forward across the breadth of the pensions landscape that works in the interest of savers and which can also deliver a meaningful contribution to rebuilding the UK economy in a more progressive manner, particularly in addressing historical structural challenges around investment in public infrastructure and over-centralisation. We hope they will inspire innovative policymakers to make stronger reforms in this crucial arena.

Finally, we want to stress our belief that any reform in this area must continue to command broad, sustained support across the political spectrum.

Recommendation 8: Utilising pension fund capital to help rebuild the nation's economic capability will require consensus over several parliaments if a successful and meaningful re-orientation of UK pension investment is to be achieved. While there remain limits as to how much one government can bind its successors in a democracy, policymakers should think about how to embed these reforms in such a way that they stand the best chance of being delivered over the long term.

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