Investment For Broad-Based Economic Growth

The UK has a large capital stock. The bulk of this comprises approximately £6 trillion of individuals' retirement monies. This is tied up in a fragmented pension fund system, insurance companies and wealth managers, invested by fund managers, often achieving low returns.

At the same time the UK is starved of capital, suffers from financial inequality and low productivity. The way these institutions are required to operate has contributed to long-term underinvestment, regional inequality, poor growth of the UK economy, and does not secure an environment safe and secure for their beneficiaries. This also represents an opportunity to mobilise capital for sustainable growth.

Regulation has been premised on ensuring individual institutions manage their risk in a prescribed manner that prejudices financial investment over investment in the real economy. It has failed to achieve security for beneficiaries as witnessed by the recent collapse in Liability Driven Investments.

To achieve a better outcome – in terms of investment into the economy, reduced systemic risk and a sustainable pension system - we propose a series of technical adjustments, but taken in ensemble they are designed to achieve transformative systems change:

Pension system

1. Consolidation of Defined Benefit pension schemes

- There are around 5,000 defined benefit schemes in the UK and they are mostly too small to have the resources to be viable. These schemes are regulated by the pensions regulator (TPR). The government needs to give a consolidation mandate to the TPR that the presumption is that schemes should merge into large entities (already existent Pensions Consolidation Vehicles (PCVs)), unless they can provide a strong case or reason not to do so, and demonstrate that they have adequate resources to fulfil their fiduciary duties.

- PCVs have the required scale and skills to invest funds effectively, in the interests of the beneficiaries, as opposed to on behalf of the financial intermediaries. A requirement to invest for the long-term with positive social returns will be a viable option for PCVs as they will have the internal capacity and market power to achieve this. This also supports the regeneration of sponsoring companies currently penalised by sponsoring a Defined Benefit scheme.

2. Introduction of Pillar 2 pension

- For most people the current UK pension system does not provide an affordable pension beyond the unfunded state pension. There now is a viable off-the-shelf solution successfully used in Sweden; which is technically a partially funded notional defined contribution scheme, overseen by a dedicated pensions agency with mandate to ensure the scheme's sustainability. The DWP will develop the design of a Swedish-style pillar 2 pension with a view to be enacted during the next Parliament.

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Regulation

Institutional investment is overseen by a range of agencies – including the Prudential Regulation Authority, the Financial Conduct Authority and the Pensions Regulator. There are differences in detail as to how they operate, but in general they attempt to ensure the integrity of investments for policyholder. This is not sufficient, either for the integrity of the system or needs of society. Regulators will therefore be required to:

- Ensure that investments are required to demonstrate that they make a positive benefit to society, as well as but beyond ensuring security for beneficiaries. It is up to the investor to disclose and demonstrate how this is achieved

- Set a targeted proportion of assets to be invested in primary investments. At the moment this is very low (circa 4%) – we propose a long-term target of 15% achieved through an annual increase on 1% per annum

Accounting treatment

The current system uses a mark-to-market approach justified by discredited financial economic theory.

- We will replace the mark-to-market approach by a mechanism design approach where the regulator considers **the required outcome of investment** (protection for beneficiary, social benefits, avoid systemic risk, objectivity) and develop accounting treatment to achieve these

- **The definition of risk** needs to be re-framed from its current equivalence with volatility, to it's actual meaning of ability to meet (long-term) liabilities. The regulator needs to encourage risk-taking, provided it is productive, but reduce supposed risk management based on financial engineering, leverage or systemic risks.

- **Avoid systemic failure:** the current tendency is for a risk monoculture which ensures low levels of individual failure but increases the probability of catastrophic systems failure (as witnessed in the recent liability driven investment (LDI) failure). In this situation the government or Bank of England are acting as a catastrophe risk insurer. Institutions which may contribute to systemic failure will be required to pay a premium. This premium could be penal, which will ensure that systemic risk is reduced as companies would be deterred from this strategy.

Investment

We will create new bodies to ensure long-term investment into the economy:

1. Improve investment industry oversight

   Create a national oversight body, (Long Term Sustainable Investment Council - LTSIC) independent of any regulatory responsibilities, able to report to Parliament on the effective functioning of our financial systems, to promote long term sustainable growth, help to support a successful, fair transition to a green economy and report on implications for increasing UK corporate productivity

2. Facilitate regionally based infrastructure investment

   National and regional development banks: UK infrastructure to work with financial regulators and the industry to support regional investment by regional funds and crowd-in investment into infrastructure.