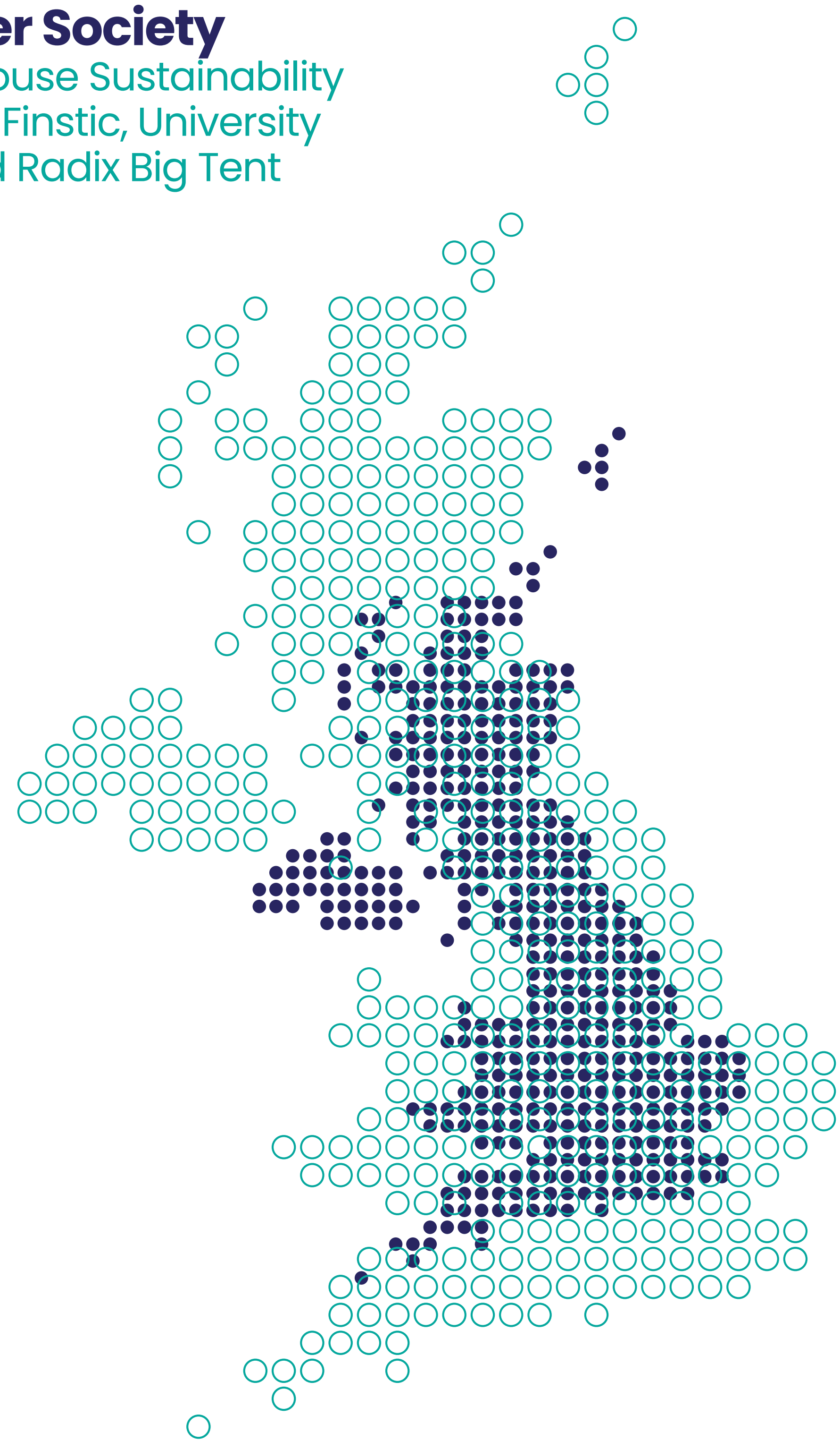
New Capital Consensus

A better investment system for all

Driving Investment for a Better Society

Chatham House Sustainability Accelerator, Finstic, University of Leeds and Radix Big Tent



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The UK's Investment and Growth Problem

The new government's desire to place UK sustainable economic growth at the top of its agenda, and to view the stock of UK savings and investment as a key driver of this growth, is a welcome recognition of the investment system's central role in driving sustainable growth and better working-lives, and in improving intergenerational fairness within a more resilient domestic framework.

Where previous governments have tended to view the investment system either as a source of taxation or systemic risk, the new government has the opportunity to recognise its more fundamental function as a critical financial intermediator, channelling money from the UK savings and investment stock to UK firms in need of growth capital. Such a view correctly locates the investment system at the centre of a what could be a virtuous spiral for the UK economy – with higher rates of investment driving a more productive economy in turn driving higher rates of investment.

However, in order for the investment system to fulfil this potential it is itself in need of reform.

New Capital Consensus (NCC) comprises a coalition of organisations brought together to create a neutral, apolitical research project and a policy discussion forum for commercial entities, think-tanks, policymakers and regulators. Our shared purpose is to identify the reform needed to enable the investment system to best intermediate between UK savers and the UK economy – or, to put it in social policy terms, to find and foster the strongest links between the UK's savings and retirement aspirations and its economic growth aspirations that drive prosperity.

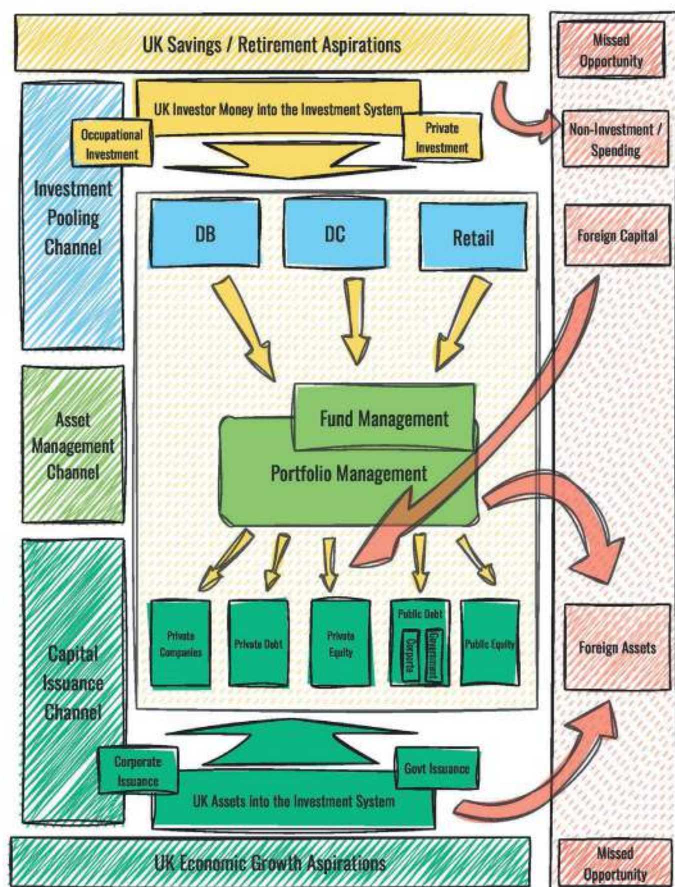
Understanding the system's current capital stocks (their size and location) and flows (together with the interconnected set of forces that shape system flow) is key to the development of effective policy solutions.

Based on 40+ 'Chatham House Rule' interviews with actors across the system NCC has generated a picture of the UK investment system as it is in reality ('warts and all'), rather than as it should operate according to 'efficient market theory' or other similar models of economic and human behaviour. We will shortly be publishing two reports detailing our findings and designed to spark debate as we move towards a consensually agreed understanding of the current system:

- **A quantitative report** identifying the precise size and location of available stocks of investment – with a focus on occupational pensions in particular (and thus the 'Retirement System'); and
- **A qualitative report** setting out the incentives, disincentives and ways of thinking that currently govern where and how private UK money gets invested together with a set of draft policy recommendations for discussion.

Our ultimate objective is to derive a set of firm policy reforms that deliver on UK political and social aspirations but do so by working with the grain of the investment system as it operates in often messy reality.

We have consciously focused on the investment system as a sub-set of the wider financial system which also includes banking and general insurance. We are also mindful of foreign direct investment into the UK economy: we believe that boosting the participation of UK investment in the UK economy will pave the way for higher levels of 'crowding in' of both foreign and domestic investment. It is also important to recognise that the bulk of investment within the system is related to retirement saving – pooling within Defined Benefit (DB) and Defined Contribution (DC) schemes and life insurance companies.



Initial Quantitative Findings

A full quantitative analysis of the UK Retirement Channel identifies the following amounts of pooled investment within the system (as at Sept 2023). Amounts held within the system's two other main stocks of investment (life insurers and ISAs) are also illustrated on an estimated basis:

Private Sector DB and Hybrid	£1,130bn
Private Sector DC	£249bn
Public Sector Funded DB[1]	£598bn
DC Master Trusts (Including NEST)	£169bn
Total in Retirement Sub-System	**£2,046bn**
Life insurance assets	£2,364bn
ISAs	£687bn

Fundamentally, our analysis seeks to **distinguish between 'productive' and 'non-productive' asset allocation** by focusing on primary over secondary investment; and on directing investment towards companies with growth strategies (R&D, expansion, upskilling etc.) over those more mature companies pursuing high dividend payment or share buyback strategies.

Our analysis indicates that:

- **The Public DB Sector is in considerably better health than the Private DB Sector**. Public Sector DB did not suffer the 31% loss in investment experienced by the private sector during the LDI crisis. It also invests more heavily in productive assets than private sector DB which invests predominantly in gilts or gilt-like instruments, such as Liability Driven Investment (LDI) strategies. The way in which strategic benchmarks are constructed (itself a result of the interplay of regulation and scheme asset allocation) lies at the heart of these different levels of performance.
- **The LDI crisis and subsequent impact on bond prices was transitory, but a reliance on market-to-market regulation led to significant and real destruction of capital (as distinct from paper losses) quantified at £700bn.** Some of this loss of capital may be recovered should interest rates decline to previous levels, but given historic interest rates were suppressed by QE, loss recovery should not be expected to be significant.
- **Industry and government data on amounts of investment capital is poor**. Without improving this data quality the quality of decision making will remain equally poor ('you can't manage what you can't measure…'). The total amount of investment capital within the system is believed currently to be at least £5trillion, and yet this remains a 'best guesstimation'. As does the precise location of each stock of investment especially in the area of retail investment pooling (ISAs, SIPPS etc.) and retail non-investment (e.g. the over cashed who should be invested).

Initial Qualitative Findings

Our qualitative analysis has identified **three key market structural problems** within the UK investment system:

- **Defined Benefit (DB) scheme fragmentation has led to a lack of trustee agency and concomitant herding behaviour,** which significantly contributed to the systemic risk losses described above. As investment mandates are outsourced en masse to third parties, asset allocation and risk management techniques have become standardised and prosaic.
- **An imbalance between Asset Owners and Portfolio/Fund Managers is leading to Asset Owners typically conforming to Portfolio/Fund management approaches and offerings.** These are often off-the-shelf and designed to suit the commercial needs of the Portfolio/Fund Manager more than those of the savers, sponsors and pensioners whose interests Asset Owners ultimately represent.
- **The trifurcation of the Savings & Investment market into three distinct but interconnected sub-markets (DB, Defined Contribution (DC), and Retail and Private Savings, such as ISAs) is over-complicated and fails to meet the needs of savers and pensioners.** Each sub-market sits within its own regulatory and market structure, imposing a patchwork onto the UK's pensions and savings channel that is both inefficient in terms of economic funding (fragmented and conflicted) and runs counter to the way that UK citizens interact with their financial futures (in the round and more often including all of DB, DC and Retail/Private provision).

[1] Funded Public Sector DB comprises the LGPS in England at Wales (£359bn) and Central Government DB schemes (£149bn), which also includes local government schemes in Scotland and Northern Ireland.

We have identified **five particularly strong incentives** that govern the flow of UK investment monies. These act as the primary drivers of the system's behaviour:

- **Regulation** – which influences risk appetite, cost consideration, liquidity management and investment choices across the system.
- **Accounting** – which continues to shape investment strategies, for example by disincentivising the operation of DB schemes (as with IFRS17 and IAS19).
- **Risk management** – which is currently focused either on volatility risk or liquidity risk, neither of which are primary risks for long-term investment but both of which dominate investment strategies and risk-sharing models.
- **Market practices** – which have been built on but now sustain outdated norms and 'ways of doing things' (often knowingly and/or out of self-interest). Certain market practices and assumptions, together with supervisory practices, are also limiting innovation and ambition.
- **Tax** – which continues to shape investment decisions and product design choice.

We have identified **four weak or missing incentives** that should play a stronger role in shaping the investment system's flow but are notably absent.

- **Return-seeking in the Capital Formation sector is weak,** with other motives (such as cost, liability and safetyism) frequently trumping return generation.
- **The Private Equity markets lack transparency** at a point when there is a considerable shift from public to private equity investment.
- **There are material gaps in certain markets** that need closing and yet there is weak incentivisation for the market to innovate. For example, retail investment platforms possess the innovative guidance tools and datasets needed to close the 'advice gap', but are prevented from deploying them by regulation and regulatory risk appetite.
- **The system is very poor at accounting for externalities,** including the future upside of productive and sustainable investment. This makes it hard to understand the true costs and benefits of investment activity.

We have identified **four key 'feedback loops'** that act to reinforce poor behaviour and/or undermine more 'productive' behaviours:

- **DB accounting standards have led to short-termism in DB scheme investment mentality.** Artificial volatility from liability measurement has pushed assets towards bond investments and leveraged LDI strategies, both obscuring and creating systemic risks. It is important to note that, despite the losses incurred through the LDI crisis, systemic risk within the system remains high and is likely to increase as more DB schemes are 'bought out' by insurance companies.
- **An over-focus on cost in DC and Retail / Private investment has led to both a passive mindset** and helped to drive consolidation within the asset management industry. Global approaches to asset allocation, adopted by larger Asset Managers, have reduced investment in the UK economy, in turn diminishing the UK share in global indices. Within the Asset Management Industry, asset-gathering (as distinct from asset allocation) is also emerging as a feedback loop that drives against productive allocation.
- **Asset Owner fragmentation has led to a lack of buyer power** which has, in turn, led to Investment Mandates that are provider-dictated. Industry approaches to 'relative' benchmarking and diversification-seeking further drive the adoption of global indices in setting pension scheme allocation which punishes investment into the UK.
- **A system-wide focus on short-term volatility over long-term risks has given rise to risk-reward aversion** among a wide range of stakeholders which in turn creates a market driven to minimise risk rather than to find the appropriate trade-off between risk and reward / return.

Taken together these factors combine to reinforce behaviours that result in a risk-averse culture that operates against the system's intermediating purpose.

Our Recommendations

Effective policy measures must target and counteract such ingrained industry practices for the UK to rebuild a growth economy to the benefit of all. We make the following recommendations, which have been designed to address the problems described above, and specifically target DB scheme fragmentation and lack of Asset Owner agency, lack of return incentives, poor risk management and to reincentivise investment in UK businesses.

Short-term recommendations (already being considered by Government at least in part)

- **Increase the level of DC contribution** – in line with original DC / Auto-Enrolment policy.
- **Continue to develop well-designed public private partnerships to 'crowd in' private investment,** making greater use of blended finance solutions.
- **Ensure government policy is particularly aligned with the UK's sustainable investment goals** - including a better acknowledgment of the strong connections between sustainable and productive goals and the systemic drivers they share.
- **Extend the role of the Regulatory Innovation Office to have responsibility for system oversight measured against system purpose** – beginning with a system purpose that delivers on social goals for individuals, the economy and society.

Medium-term recommendations

- **Facilitate the consolidation of private DB pension schemes** – permitting life insurers to set up Superfunds outside their Solvency II ring-fences - to sit alongside other new providers of capital.
- **Remove the requirement for daily liquidity in the DC and Private / Retail Investment markets** – on the grounds that the benefits of daily dealing (immediate subscription / redemption) are increasingly outweighed by the cost that a daily liquidity mindset brings to asset allocation.
- **Require asset owners to issue Investment Mandates that better reflect the needs of savers** – in particular stop investing long-term money on a short-term basis – invest in way that focuses on meeting objectives of savers.
- **Revisit regulatory and industry risk measures to free up investment strategies and support institutional risk-sharing with clients** – beginning with the system's current unhealthy fixation on volatility and liquidity risk at the expense of duration risk and risk to return (alpha over beta).
- **Change tax incentives/disincentives to operate at the asset level as well as at wrapper level** – to boost the appeal of productive UK investment and to put equity investment on a par with debt investment.
- **Introduce mechanisms to support pensions schemes 'run-on' strategies** – to extend investment durations and not leave considerable amounts of DB money on the table in the rush towards 'buy-out'.
- **Empower sustainable investment by making tax incentives dependent on adherence to stewardship obligations.**

Longer-term recommendations (needed to create the right regulatory incentives for a growth economy and to encourage innovation in financial services).

- **Review the regulatory structure and its modus operandi** – including where the numerous regulators overlap, underlap and encounter conflicts of interest. Notwithstanding current levels of regulatory fatigue, the government needs to at least begin repositioning the regulatory structure to respond to the challenges of the next two decades rather than the problems of the last three.
- **Rebalance the role of regulators to create the right trade-off between the achievement of savers' objectives and the security of institutions** – moving away from the regulators' current singular focus on balance-sheet resilience and desire to have a 'no-risk' system to reflect the reality that there is no return without risk, and there is no economic growth without investment returns. The regulators' conception of and appetite for investor-level risk-taking (current 'safetyism') also needs addressing if we are to avoid 'the stability of the graveyard' for investors and the economy.
- **Rationalise and modernise the regulatory approach** – paying particular attention to the way in which technology, AI and financial data might be used to deliver more productive outcomes, as well as acknowledging increasingly digitally savvy and self-protecting consumers.

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About New Capital Consensus

New Capital Consensus is a coalition of non-commercial, apolitical organisations that have come together to explore how the current UK investment system contributes to the country's current problems of low productivity, inequality and low levels of investment. Its objective is to find ways to release investment capital to address societal problems, like those above and in particular, to green the economy.

We believe addressing these problems requires us to:

- Understand how the system operates holistically and as a complex adaptive system;
- Recognise the source of private investment resides predominantly in consumers retirement savings;
- Develop a clear map of the system and an accurate quantification of and view on system stocks and flows;
- Through this, identify the policy levers capable of redirecting system flows toward more productive uses that benefit savers.

We will focus not only on those beneficial policy changes that can be affected within the current system but - recognising that current market structures have developed in an anachronistic way - also those that require changes to current market structures, approaches and beliefs.

The NCC coalition of organisations comprises **Finstic (Financial Systems Thinking Innovation Centre)**, **University of Leeds** and **Radix Big Tent** and is incubated at **Chatham House Sustainability Accelerator**.

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