NEW FINANCIAL
Rethinking capital markets

UK CAPITAL MARKETS: A NEW SENSE OF URGENCY

ANALYSIS OF THE 'PARALLEL CRISIS' IN UK PENSIONS AND CAPITAL MARKETS - AND HOW TO ADDRESS IT

September 2023

By William Wright

In partnership with:

abrdn citi

> This report highlights the emergence of two separate but related structural problems in UK pensions and capital markets that are undermining the long-term prosperity of the UK. Addressing inadequate pensions for millions of people in the next few decades and rebuilding a virtuous circle of investment and growth in capital markets will require a renewed and concerted focus in government, regulators and the industry.

Capital markets in the UK - a new sense of urgency

Over the past few decades, layers of well-intended regulatory reform have created a framework and culture in UK pensions that seems actively designed to eliminate risk and discourage long-term investment. Pension funds have had their risk appetite kicked out of them, and companies have been incentivised to reduce volatility in their pension schemes, shut them down, and offload them. This has sucked hundreds of billions of pounds of natural demand out of the UK market, leaving the UK reliant on overseas investment in some critical sectors. And millions of individuals saving for their pension have been left facing a future pension penalty.

This report argues that most of the debate around UK pensions and capital markets has been looking at this problem from the wrong end of the telescope. Instead of asking 'how can we get more money from UK pensions into more productive investment?' we have reframed the essay question to instead ask 'how do we enable the pensions industry to do a better day job of providing a secure and comfortable retirement for millions of people in every corner of the UK?'.

The more closely we have analysed this problem, the more it has become clear that there is not one crisis but two related crises. First, while the UK pension system looks robust at first glance, there is a storm brewing for millions of people in the coming decades in terms of an inadequate income in retirement. Despite the success of auto-enrolment, nearly a third of the UK workforce are not saving for a pension at all; most people are not saving enough; and structural and cultural challenges embedded in the UK pension system (such as fragmentation and the focus on cost rather than value) add up to smaller pensions in future.

And second, the structural decline in UK capital markets and long-term investment by UK investors has now reached the point of crisis. Despite having highly developed capital markets and deep pools of long-term assets, the UK stock market has stagnated over the past decade; UK growth companies are increasingly reliant on overseas investors; and the UK has among the lowest rates of investment, productivity, and economic growth of its peers.

What to do about it

There is a unique window of opportunity to address this problem. In the short term, the UK should rapidly increase pension contributions; push ahead with consolidation and the Mansion House reforms; urgently review how to shift the regulatory and cultural mindset in pensions and approach to risk; and launch a new pensions commission to design a pension system fit for the next 50 years. In the longer term, it should embrace bolder ideas such as the radical consolidation of DC pensions from over 3,000 schemes to just a few dozen; or start to shift the huge unfunded public sector pension schemes such as the civil service and NHS to a funded model.

The potential prize is huge: hundreds of billions of pounds in investment in productive assets could be unlocked with relatively minor reforms; millions of individuals could look forward to a more comfortable retirement; and the UK could have a giant state pension fund with more than £2 trillion in assets at its disposal within 25 years. The best time to have tackled this would have been a few decades ago. The second best time is now.

This paper is divided into two parts: the report itself is just 12 pages long; followed by a detailed data pack on the parallel crises in pensions and capital markets, and a more detailed analysis of our proposals for reform. Thank you to the many firms and individuals who have fed into this project with their ideas and expertise over the past year. Thank you to Toby Nangle for his exhaustive and diligent research, and to our members for supporting our work in making the case for bigger and better capital markets. And thank you to abrdn and Citi for their generous support for this important project. The recommendations in this paper are mine and New Financial's alone and should not be taken as representing the views of our partners on this project.

William Wright
Managing director
william.wright@newfinancial.org

Here is a short summary of the report:

1. **A parallel crisis:** this report analyses what we see as a parallel crisis in the UK. First, a crisis in future pensions provision driven by structural problems in the UK pensions industry; and second, a separate but related crisis in UK capital markets, particularly the collapse in long-term domestic investment in productive assets. These combined challenges are of critical importance to the long-term prosperity of the UK.
2. **The crisis in UK pensions:** the structure and regulation of the UK pension system in terms of patchy participation rates, low contributions, fragmentation, a focus on 'cost at all costs', narrow asset allocation, and mediocre returns has undermined the risk profile of pensions and is storing up trouble for millions of individuals over the next few decades who will face an inadequate income in retirement.
3. **The crisis in UK capital markets:** the structural decline in UK capital markets over the past few decades has reached a crisis point. The number of listed companies has virtually halved over 25 years, new issue volumes have collapsed, valuations have stagnated, and the UK's share of global markets has fallen. The appetite among UK investors for long-term investment in UK productive assets has shrunk, and the UK is increasingly reliant on overseas investors to provide growth capital and investment in critical infrastructure.
4. **Reframing the essay question:** in light of this parallel crisis and the often-challenging debate over the past year we have reframed the essay question from 'how do we get pensions to invest more money in UK growth companies and infrastructure?' to 'how do we ensure that the pensions industry can do a better day job of providing a secure and comfortable retirement for millions of people in every corner of the UK?'.
5. **A social contract:** the asset allocation of UK pension funds should not be mandated. However, given the generous £48bn in net tax reliefs paid by UK taxpayers on pension contributions in 2021 (more than the entire defence budget), it is not unreasonable that there should be some form of quid pro quo.
6. **Economic sovereignty:** in a globally-connected economy you can argue that it should not matter where companies get investment from or where they choose to list. However, raising capital from non-UK investors or on overseas markets should be an active choice - not the only available option. The risk is that the jobs, investment, growth, and returns companies generate migrates overseas over time.
7. **A good start:** the UK government has made a good start on pensions reform with the Mansion House reforms outlined last month and the programme of Edinburgh Reforms for capital markets last year. There is a need to go a lot further on pensions reform and to learn from other highly-developed pensions systems such as Australia, Canada, Sweden and the Netherlands as to what does and doesn't work.
8. **Reforming pensions:** in the short term the UK should remove obstacles to wider participation and agree a glidepath to higher pension contributions. Given the critical importance of pensions there is a strong case for a pensions commission with cross-party support. While corporate DB pensions are the largest part of the market and may offer some scope for reform, efforts should focus more on DC pensions (with more radical consolidation into a series of 'super trusts') and on public sector pensions.
9. **Reforming capital markets:** the UK has all the right building blocks in place to develop bigger and better capital markets. The government and the industry should work together across sectors to further the Edinburgh Reforms and develop a more strategic plan that joins up the dots and builds on these strengths.
10. **Reforming the wider economy:** ultimately, the best way to boost long-term investment in the UK is to make the UK a more attractive investment proposition. Beyond pensions and capital markets reform, the UK) will need to develop a clearer and more consistent industrial strategy focused on delivering better infrastructure (in the broadest sense) and on a handful of key sectors and priorities.

'The nastiest, hardest problem in finance' - William Sharpe, Nobel Prize-winning economist

At first glance, the UK has one of the most robust pension systems in the world. It has the second largest pool of long-term capital after the US with more than £5 trillion in pensions and insurance assets; nearly 80% of employees are saving for a pension; and annual pension contributions from employers and employees add up to £75bn a year. However, the structure of the UK pension system (in terms of participation, contributions, fragmentation, costs, asset allocation, and performance) is causing unintended behaviours, a lack of risk appetite, and storing up trouble over the next few decades for millions of individuals who will face an inadequate income in retirement.

29% Proportion of the UK workforce not contributing to a pension

1) Patchy participation rates: auto-enrolment has been a huge success over the past decade, with the participation rate of employees nearly doubling from 46% to 79%. However, nearly 30% of the UK workforce and 40% of the working age population are not saving for a pension at all.

8% Minimum required pension contribution as a % of eligible earnings

2) Low contribution rates: the minimum pension contribution of 8% of eligible earnings for defined contribution pensions is woefully inadequate compared with other countries. It is also skewed to individuals rather than employers and should be increased to at least 12% in the near term and probably closer to 15% in the longer term.

33,850 Total number of pension schemes in the UK

3) Fragmentation and complexity: there are nearly 34,000 different pension schemes (which seems like at least 33,000 too many) and more than 50 million individual pension pots. This increases costs and inefficiency, fragments skills and expertise, and limits the asset allocation of pension schemes.

65 bps Estimated total costs paid by pension schemes and their members each year

4) The focus on 'cost at all costs': UK pensions are locked in a doom loop with sub-scale pension schemes chasing lower costs instead of focusing on net returns, which limits their asset allocation and performance. The creates a paradox where the average cost of UK pensions is higher than many larger schemes in other countries that have a much broader asset allocation.

<1% Share of UK pensions and insurance assets invested in unlisted UK equities

5) Asset allocation and performance: the shift by DB pensions from equities to fixed income over the past 25 years has sucked hundreds of billions of natural demand out of the UK market. A low allocation to equities, private markets and infrastructure has delivered middling real returns for UK schemes of around 4% a year - lower than other comparable countries.

£3,150 Average annual pension income last year from individuals buying an annuity

>>> Bad outcomes: over the next few decades millions of people will retire with inadequate pensions. Roughly a third will struggle to meet their basic needs and average private sector pensions are likely to be less than half the level of the public sector. Increased life expectancy, stagnant real incomes, the rising cost of long-term care, lower home ownership rates, and a falling dependency ratio will exacerbate this problem.

Sources: New Financial, ONS, TPR, LGPS Advisory Board, PPF, DWP, FCA, IFS, ABI

A high-quality problem

The UK has among the largest and deepest capital markets in the world, but the structural decline in UK capital markets over the past few decades has reached a crisis point. The number of listed companies has virtually halved over 25 years; the value of UK listed companies has flatlined over the past decade; and the UK market now trades at a discount of over 40% to the US. The overall appetite among UK investors for long-term investment in UK productive assets has collapsed; UK tech and growth companies are increasingly reliant on overseas investors and capital markets for investment; and the UK has effectively outsourced investment in its critical infrastructure to overseas investors and companies. This is contributing to sluggish levels of investment, growth, and productivity.

1,343

Net decline in the number of UK listed companies since 1997

1) A structural decline: the number of UK listed companies has virtually halved since 1997, the number of new issues has dropped by two thirds and the amount of money raised by new issues has fallen in real terms by a third. Last year was the worst year for new issues in real terms since 1980.

£1.8 trillion

Lost value of UK stocks compared with US market over the past 20 years

2) Stagnation: the UK equity market is the only major developed market to have shrunk relative to GDP over the past 20 years (from 104% of GDP to 94%, while the US has increased from 101% to 156%). The UK stock market is now worth the same in real terms as it was a decade ago.

-46%

Valuation discount of the UK stock market compared with US

3) Composition and valuation: the UK market is dominated by 'traditional' sectors with just 16% of the market coming from companies that could be described as 'growth' stocks (compared with 42% for the US). The UK trades at a discount of 46% to the US stock market overall and at a smaller discount to European markets.

40%

Share of UK early-stage investment done by UK investors

4) Access to growth capital: while early-stage investment in the UK has grown rapidly over the past few years, UK growth companies rely on non-UK investors for 60% of their funding (and more than 70% for deals larger than $100m). The limited availability of growth capital is pushing a growing number of UK companies to the US market for their IPO.

60%+

Average non-UK ownership of critical national infrastructure

5) Economic sovereignty: the UK has effectively outsourced investment in critical infrastructure (such as airports, water, and renewables) to sovereign wealth funds, Canadian and Australian pension funds. The returns from this investment are funding pensions overseas, while UK pension funds are either unable to spot these opportunities or unable to take advantage of them.

0.3%

Average annual growth in UK productivity since 2008

>>> Bad outcomes: this risks becoming a self-fulfilling doom loop of less investment and lower demand from domestic investors, and lower valuations, It is also contributing to some of the lowest levels of business investment, real GDP growth per capita, and productivity growth in the G7.

Sources: New Financial, LSEG, Citi, S&P, Preqin, OECD

A parallel crisis

The parallel crises in UK pensions and capital markets each need to be urgently addressed in their own right: millions of people need a significant boost to their future pensions, and capital markets in the UK need a significant reboot. But there is a danger in thinking that pensions are a miracle cure to solve the challenges in capital markets, that a series of supply side reforms can solve the demand side of the problem, or that UK growth companies can ride to the rescue of the pensions industry. However, a happy consequence of the sort of reforms needed to address the pensions crisis is that they would also enable the pensions industry to play a bigger role in driving investment in UK capital markets - so long as they are accompanied by a more strategic programme of reforms in capital markets and the wider economy. Here are some broad principles for the reform process ahead:

1. **The magic pensions pot:** at times in this debate pensions have been 'blamed' for the challenges in UK capital markets and simultaneously seen as a magic pot of money which the government, companies, and 'the City' can dip into at will. There is a stark disconnect between the abundance of long-term capital in the UK and the drought in domestic investment in growth companies, infrastructure and other productive assets. But much of this is the result of UK pension having had their risk appetite kicked out of them over the past few decades by the cumulative impact of well-intended regulatory reforms. In the long-term this can only be solved by addressing the structural problems in UK pensions that are undermining the future pensions of millions of individuals and limiting pension funds from investing more in the UK.

2. **Members first:** any reforms to UK pensions should put the interest of individuals saving for their pension first. They can do this in at least two ways: directly, by improving long-term net returns and reducing costs; and indirectly by improving overall economic growth or improving the funding position of defined benefit schemes. Everyone should be wary of overstating these potential benefits. That's why we have reframed the question from 'how do we get pensions to invest more money in UK growth companies and infrastructure?' to 'how do we ensure the pensions industry can do a better day job of providing a secure and comfortable retirement for millions of people in every corner of the UK?'.

3. **A social contract:** part of the resistance to change in the pensions industry to reform has been triggered by a sense that the reforms interfere with their independence and fiduciary duty. However, there is a strong argument that UK pensions and the system around them have an additional social responsibility: UK taxpayers paid over £48bn in net tax reliefs on pension contributions in 2021 (more than the entire defence budget), and nearly 60% of that went to higher or additional rate taxpayers. It is not unreasonable that there should be some form of quid pro quo for this generosity. The more connected people feel with their pensions, the stronger the social licence for the industry and capital markets will be.

4. **Enabling not mandating:** mandating pensions to invest in a particular way is unlikely to be an effective part of the solution. The focus of reform should instead be on enabling and empowering them to do so. Given the structural challenges in the UK pension system and the barrage of reforms to regulation, taxation, and accounting standards over the past few decades, it is not surprising that pensions have narrow investment horizons and mediocre performance. Even if most schemes wanted to invest more in UK growth companies or infrastructure they have limited incentives, capacity, or ability to do so.

5. **The bigger picture:** the UK has all the right building blocks in place to build bigger and better capital markets. But lasting reforms that will benefit individuals saving for their pension, UK capital markets, and the wider economy will require a more co-ordinated and strategic approach than has sometimes been apparent in the post-Brexit regulatory reform programme so far. The sort of structural reforms needed to pensions and capital markets also go beyond party politics and electoral cycles. They will require a long-term commitment across the industry and across the political and regulatory spectrum to develop the best possible framework that enables UK pensions and capital markets to thrive.

Stephen Bird
Chief Executive Officer,
abrdn

Putting the saver first

The shortcomings in UK retirement provision are well recognised: an ageing society with high dependency on the state; growing intergenerational inequality as defined benefit schemes are no longer available; emerging disparity between public and private sector provision; serious gaps in coverage for the self-employed; and finally, patchy private retirement savings with too many people not saving enough or, worse, not saving at all.

The challenges facing UK capital markets are a more recent phenomenon but now high on the political and policy agenda - and rightly so. Vibrant capital markets are vital to attract the domestic investment on which our future prosperity depends. As important, their international competitiveness is essential to the health of our economy and, consequently, through tax revenues generated, the funding of public services.

Having spent much of my career in the Far East and US, I have seen a variety of approaches to funding retirement and building successful capital markets. It is therefore encouraging to see these two issues now being considered in conjunction in the UK.

While the UK's immense pool of pensions assets is evidence of our historic success in giving people financial security, we must now build a framework for retirement provision that reflects both a very different economy and employment model. Our future fiscal sustainability is dependent upon getting this right.

Finding sustainable solutions to these challenges requires a boldness of political vision and consensus - as happened with the much-copied introduction of auto-enrolment workplace pensions. It also requires pragmatism and a mature risk/reward mindset from regulators.

The New Financial team has produced a thought-provoking report based on careful analysis evidenced by diligent research. Through the prism of 'putting the saver first' it progresses the debate on how to address some of the biggest challenges facing our economy and society, even if some potential solutions may not be to everyone's liking. I very much hope that it is received in this spirit.

Stephen Bird
Chief Executive Officer
abrdn

David Livingstone
Chief Executive Officer,
EMEA
Citi

Taking risk for reward

Reform is hard work. It requires recognising the problem, undertaking analysis, identifying solutions, and often making difficult choices. With regards to the pressing debate on pension reform, this report undertaken by New Financial is a positive contribution on each of these dimensions, and we at Citi are delighted to sponsor it with abrdn.

Research shows that the allocation by UK investors to UK equities has been in decline despite the premium long term returns from that asset class. This underinvestment matters for the British public and the economy. It also matters for Citi and our clients; a successful financial services sector in the UK, with vibrant equity markets at its heart, is undoubtedly a public good.

The report rightly highlights that the UK starts from a position of strength with nearly 80% of private sector employees saving for a pension. However, to secure the returns needed for our collective long-term prosperity, the level of long-term equity investment by UK investors – institutional and retail – needs markedly to increase. Employers as well as employees must play their part in meeting this challenge, including increasing their contributions.

Most important will be to rethink collectively the approach to concepts of risk and return in the UK. Perceived risk minimisation in the pension industry over the last three decades has undermined potential returns and weakened UK capital markets. In seeking to manage one risk, the system has overshot by exacerbating another risk under the surface – retirees in the UK lacking the financial capacity to maintain a decent standard of living. We all need to answer the key question – is the pension system delivering for pensioners?

Getting an economically rational approach to risk back into the system will take political will and private ambition. Reaffirming the objectives, duties, and liabilities of pension fund sponsors and trustees to include longer-term, net investment returns will be fundamental.

How can we make share ownership an aspiration equal to that of home ownership? People need to be on an equity escalator as well as the property ladder. Education will have a central role to play in engendering an understanding of investment risk, reward, and the power of compounding. We could kick-start a new era of retail investment by creating the universal pension and investment account New Financial recommends. Perhaps making National Insurance contributions personal to the individual would be a place to start.

Citi very much welcomes this report and its contribution to reform.

David Livingstone
Chief Executive Officer
Europe, Middle East, and Africa
Citi

A commitment to reform

Here is a summary of our proposals for reform to UK pensions to help create a virtuous circle of investment and growth and to help drive the long-term prosperity of the UK. These proposals are designed to stimulate debate, and some are more practical than others. There is no such thing as an 'easy option' in pensions reform so we have divided these proposals into i) short-term / relatively easy reforms ii) medium term / harder options; and iii) longer term / more radical options. We explore these proposals in more detail from page 36, along with more suggestions for capital markets reform and reforms to the wider economy.

>>> Short-term / relatively easy

1) Increase contributions: commit to a glide path of increasing minimum DC pension contributions from 8% to 12% in the near term and fix the imbalance between employer and employee contributions (perhaps using the plan already outlined by the ABI). This would bring the UK closer to other comparable markets and more in line with the sort of contributions originally envisaged by the Pensions Commission in 2006 when it proposed auto-enrolment. Ideally contributions would rise in the longer term about 15%.

2) Wider participation: remove the remaining age and earnings barriers to auto-enrolment as proposed in a private members bill working its way through Parliament. Introduce a staggered increase in NI contributions for the self-employed that could be allocated to a default pension such as Nest, potentially bringing more than three million people into saving for their pension.

3) Pension pot consolidation: build on the work done by the industry and Work and Pensions Committee to introduce an automatic 'pot follows member' system for DC pensions when people move jobs unless they opt-out. This would reduce the chronic inefficiency of having roughly 40 million individual DC pension pots.

4) Rethinking risk, regulation and culture: launch a Hill / Kalifa / Austin-style review of the cumulative impact of pension reforms over the past few decades that have created a culture and supply chain of risk aversion from the top down and through the entire system (scheme sponsors, trustees, consultants, and asset managers) with input from across the industry to provide a blueprint for reforming the regulatory framework around UK pensions. This review would identify how pension funds - particularly defined benefit schemes - have had their risk appetite kicked out of them over the past few decades and outline the scope for encouraging a broader approach to risk and asset allocation across regulation and the industry.

>>> Medium-term / harder

5) Turner 2.0: pensions reform goes beyond party politics and electoral cycles. A decade on from auto-enrolment, build a cross-party consensus to launch a new pensions commission to follow the Turner Report from 2004-06 to review how auto-enrolment is working and design a UK pension system that is fit for the next 50 years based on the essential building blocks of successful comparable systems (such as higher contributions and a focus on scale and efficiency). Pensions last a long-time - there is no need to rush.

6) Regulation & data: review and reform the regulatory perimeter of pensions which is currently split between the TPR, FCA, and PRA to improve policy, reduce cost, concentrate expertise, and significantly improve the surprisingly poor quality and consistency of data on pensions.

7) DB consolidation: encourage and facilitate the voluntary consolidation of corporate DB pension schemes through superfunds or the PPF as a public good to reduce costs, complexity, rents, and to improve the funding status of schemes. Build on the review of the pensions framework to enable schemes that are still partially open or have a longer glidepath to closing completely to invest in a wider range of assets - but don't bank on superfunds flying off the shelves or consolidation unleashing a wall of money into UK unlisted or listed equities.

7) DB consolidation (continued): develop a framework to enable smaller schemes or schemes that are unlikely to reach the level of funding required for a buyout to fold themselves into a revised version of the PPF alongside its existing mandate as a pensions lifeboat. While this is unlikely to unlock a wall of money into UK listed equities (the PPF's allocation to all listed equities is just 6%) it could encourage billions of pounds into private capital and infrastructure debt. Ultimately, the big question for government and regulators is whether the pendulum has swung too far on seeking to eliminate risk on DB schemes that have decades still to run. Mature schemes have no incentive today to take any investment risk and are effectively required to invest in gilts, fixed income, and cash. We think there is a potential addressable market of about £300bn in assets that could unlock £30bn to £60bn in investment.

8) Pension buyouts: given that the entire DB pensions system is designed to incentivise companies to close and offload their pension schemes, the government and the industry should accept that roughly half of corporate DB schemes today will likely be bought out in the coming decade - around 1,000 of them are sufficiently well-funded to be in a position to do so today. The government should ensure that reforms to Solvency II actively encourage and incentivise insurance companies to allocate a significant proportion of these assets (perhaps a quarter) into socially-useful real assets like housing, infrastructure, and renewable energy.

>>> Longer-term / more radical

It is entirely up to this and future governments how radical they want to be with pensions reform. While the above measures would help improve outcomes for millions of individuals and enable UK pensions to invest in a broader range of assets, they are unlikely to lead to a revolution in how the pensions industry works and what it invests in, or a revolution in UK capital markets Here are some longer term and more radical suggestions:

9) A universal pension and investment account: pensions are as fundamental a part of life as work and taxes. Create a universal pensions and investment account for every individual in the UK (ideally at birth and linked to their NI number or future digital ID) as a single flexible vehicle for their pensions, savings, and investment products over the course of their lives. This would remove the need for anyone to ever physically set up a pension account and accelerate the development of a one-stop pension dashboard. Ideally, these accounts would be seeded with £1,000 (or more) at birth to give people a head start.

10) A 'super trust' model: accelerate the the consolidation of DC pension schemes with a long-term aim of building a radically simplified system of around 20 'super trusts' with around £50bn+ in assets each - closer to the Australian system. These schemes would operate across firms, industries and regions, and would be able to operate at similar or lower levels of cost as they do today but with a much broader asset allocation. Individuals would be automatically enrolled into them by their employers.

11) LGPS: turbo-charge the proposed pooling of assets of local government schemes by consolidating the 86 administering authorities behind them to create a single globally-significant pool of capital with around £400bn. This would effectively create a British sovereign wealth fund and would enable members to save more than £1bn a year in costs (which compounds into £45bn in today's money over 25 years).

12) Unfunded public sector schemes: the potential key to unlocking investment at scale in UK productive assets is to convert the huge unfunded public sector pensions schemes such as the NHS and civil service schemes into funded schemes over time. These schemes have over £2 trillion in liabilities (but zero assets) and are already guaranteed by the government. The government could shift them onto its balance sheet, seed them initially with unmarketable gilts, and shift over time to marketable gilts (providing a willing buyer for future UK government debt). At the same time, introduce a staggered shift over 10 years from notional to funded contributions. On our calculations, within 25 years you would have a fund worth more than £2 trillion from contributions alone - and not long after that you could be talking serious money.

Fantasy pensions

Pensions and capital markets reform is complicated and there is no single lever that the government or the industry can pull to transform things overnight. However, it can sometimes be useful to play 'fantasy pensions' and estimate the directional impact of potential reforms on outcomes for individuals saving for their pension and on the availability of capital for investment. Here is a selection of 'what if' estimates based on some simple but realistic assumptions. They are likely to be a few billion out here or a few tens of billions off there, but every little helps. We hope they provide food for thought about what the industry and its role in UK capital markets could look like in the coming decades.

£42 thousand

>>> Increasing contributions

Raising minimum pension contributions from 8% to 12% could increase the value of typical pension pot over 30 years by £42,000 in today's money. It would also increase total annual contributions by about £12 billion. This assumes £1,500 a year in contributions (representing 12% of pensionable earnings), earnings rising at 2.5% a year and a 4% real return, which would add up to £125,000 (compared with a pot of £83,000 based on starting contributions of £1,000).

£175 billion

>>> The rise of defined contribution

Assuming DC pensions assets grow in the next decade to £1.25 trillion and retain their 14% current allocation to UK equities, they would own £175bn of UK equities compared with £84bn today. If they increase their allocation to unlisted equities to 5% (more than double where it is today) it would translate into £63bn in unlisted equities. Up to third of this could be invested in UK unlisted equities.

£300 billion

>>> Rethinking defined benefit pensions

There is a potential 'addressable' market in DB pensions of around £300bn to adopt a broader asset allocation (if you strip out schemes that are completely closed, assets servicing retired members, half of assets servicing deferred members, and big active schemes like USS). If 10% to 20% of this could shift into listed / unlisted equity or alternatives, that adds up between £30bn to £60bn.

£2.1 trillion

>>> The elephant in the room

If the UK converts the huge unfunded public sector pension schemes like the NHS and civil service to a funded model, it could have a giant state pension scheme with £2.1 trillion in assets in today's money within 25 years (assuming you shift contributions to unfunded schemes of £45bn a year to a funded model over 10 years, a 4% real return, 2.5% earnings growth and 0.3% workforce growth).

£125 billion

>>> Putting pension buyouts to work

If pension buyouts keep up their current annual rate of £50bn a year and reforms to Solvency II enable a quarter of this to be invested in debt issued by infrastructure, housing and renewable energy this would unlock around £12.5bn a year in socially-useful investment or £125bn over the next decade.

83%

>>> Increasing pensions coverage

If the UK removes the remaining earnings and age limits on DC pensions and successfully encourages half of self-employed workers to save towards a pension, pensions coverage would increase to 83% of the workforce, up from 71% today.

£1 billion

>>> Rethinking costs

The cost of running the £370bn LGPS scheme is 58 basis points a year. If it had the same costs as USS (29bps) or the Canadian CPPIB scheme (27bps) it would save roughly £1bn a year for members. This compounds into £45bn over 25 years assuming a 4% real return.

Sources: New Financial estimates

A good start

In July the government outlined a swathe of reforms to pensions and capital markets in the Chancellor's annual Mansion House speech with the aim of improving outcomes for individuals saving for their pensions and increasing the availability of funding for high growth companies. Overall, the Mansion House reforms are a good start to a long and hard process of pensions reform: they represent a significant acceleration in intent and they have avoided mandating pension schemes to invest in particular assets. However, there is a lot of scope to go much further in addressing the looming crisis in pensions and on their own the reforms will not have a transformative long-term impact on pensions or the wider state of UK capital markets. Here is a short summary of the main reforms:

- **The compact:** the government and Lord Mayor of London have brokered a compact with nine of the largest providers of defined contribution pensions providers to allocate at least 5% of their default funds to unlisted equities by 2030 (potentially increasing investment by £50bn). The government fell short of seeding a 'future growth fund' to facilitate this but has asked the British Business Bank to explore the role government could play in backing such a fund. *This is a good start as more than 90% of DC members invest their pension via default funds which are still actively seeking growth. But the target is not focused on unlisted UK companies, and the lack of a central vehicle to facilitate investment at scale will make this target harder to achieve and limit participation.*

- **Consolidating DC pensions:** the government wants to accelerate the consolidation of DC schemes by extending the 'value for money' framework (that requires individual schemes to focus on value instead of just headline costs). It has also published a consultation response to accelerate reform of the millions of individual pension pots, and is publishing a response on collective DC, a form of pension that better shares risk between scheme members and different generations. *More consolidation in DC pensions is welcome but the real prize is radical rationalisation of DC schemes from over 3,000 (excluding 26,000 micro-schemes) into a much smaller number of multi-employer schemes common in markets like Australia, Denmark, and the Netherlands.*

- **Consolidating DB pensions:** the government plans to create a permanent regulatory regime for 'superfunds' to accelerate the consolidation of more than 5,100 corporate DB schemes, the largest single pool of UK pensions with around £1.5 trillion in assets. This is a highly fragmented and inefficient market: more than 70% of DB schemes have assets of less than £100m. It has also launched a consultation to explore the role the Pension Protection Fund (PPF) might play in driving consolidation. *Improving the efficiency of DB pensions would reduce the rents extracted from schemes, reduce costs, and help improve the funding position of schemes. While the PPF can play a role in consolidating willing schemes, there is limited appetite for 'superfunds' and - given the risk aversion embedded in DB pensions by regulation over the year - consolidation would unlock a limited amount of investment. Many DB schemes are heading towards a buyout, where some of their assets can be invested in assets such as housing, infrastructure, and renewables.*

- **Consolidating LGPS:** the government wants to accelerate the consolidation of the £370bn Local Government Pension Scheme by requiring the 86 local authorities behind it to pool all of their assets by March 2025 (roughly half of these assets are currently pooled across eight separate pools). It has also launched a consultation into setting a target asset allocation for LGPS of 10% to private equity, roughly double its current level. *Asset pooling looks good on paper but since its introduction the annual running costs of the LGPS scheme have increased by a quarter. A more radical solution would be to consolidate the 86 administering local authorities behind the LGPS assets to create a single globally significant institutional investor.*

- **Capital markets:** the government is following through on its Edinburgh Reforms package outlined last year by simplifying the prospectus regime, abolishing EU rules such as the share trading obligation and double volume cap, reforming equity research in the wake of the review by Rachel Kent, and backing plans by the London Stock Exchange to launch a hybrid market between public and private called the 'intermittent trading venue'. *Every little helps when it comes to removing regulatory barriers to bigger and better capital markets but there is still a sense across the industry that the UK needs a more co-ordinated strategy for capital markets reform.*

The crisis in UK pensions

The crisis in UK capital markets

Addressing the problem

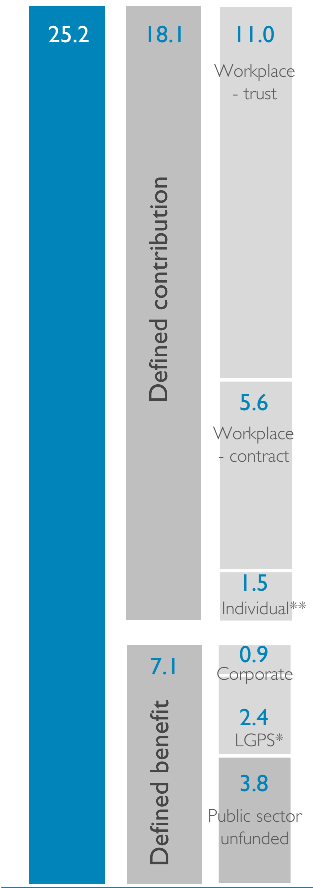
The crisis in UK pensions

While the UK has the second largest pool of pensions assets in the world and has made huge progress on pensions participation over the past decade since the introduction of auto-enrolment, the structural weaknesses embedded in the UK pensions system are storing up a future crisis for millions of individuals in their retirement.

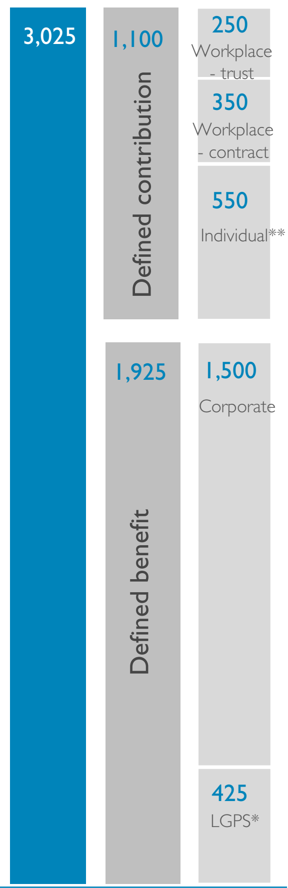
This section maps the different challenges in the UK pensions systems across a range of factors including: the complex and fragmented structure; low participation in some parts of the workforce and population; low contribution rates; a focus on costs at all costs; limited investment horizons; and middling performance.

I) An embarrassment of riches?

i) By active members (m)

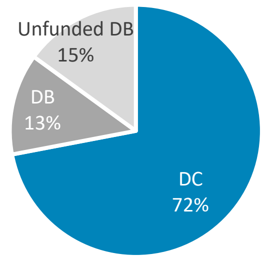


ii) By value of assets (£bn)

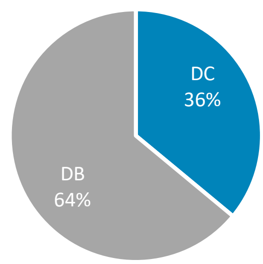


Source: *New Financial, ONS, TPR, LGPS Advisory Board, PPF, DWP, FCA, pension scheme accounts*

iii) Share of active pension members by type of scheme



iv) Share of pensions assets by type of scheme



Notes:
** LGPS includes equivalent schemes in Scotland and NI*
*** Individuals: 3.7m people paid into a non-workplace personal scheme in 2021. We estimate that this is the sole pension for 1.5m of these people.*
+ this chart excludes assets of pensions that have been bought-out and the assets backing individual annuity or drawdown pensions in payment

A complex framework

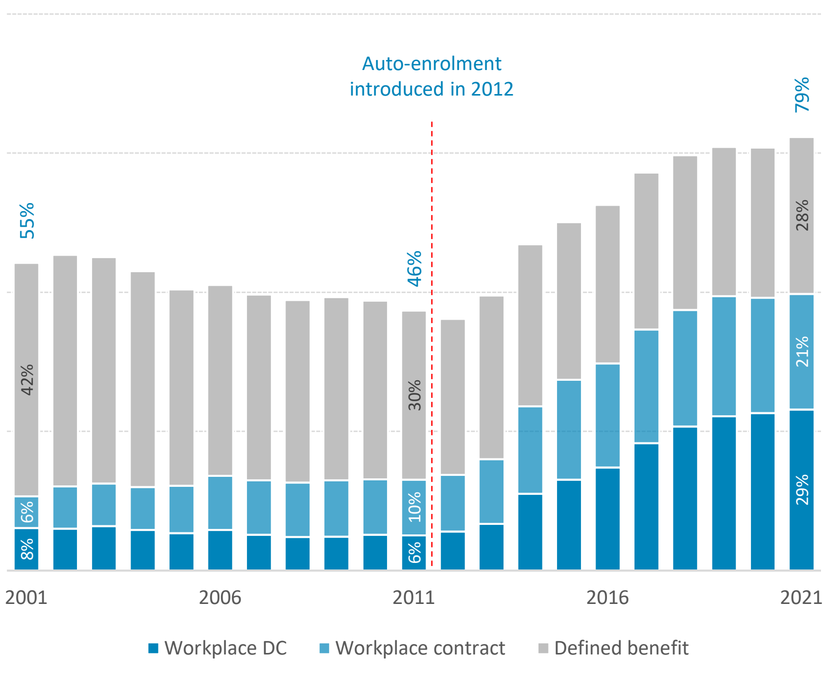
Before diving into the debate on the state of UK pensions it is worth pausing to understand what the pensions landscape looks like today. In some respects, there is no such thing as 'pensions': instead, there is a complex patchwork of different types of pension that we have simplified in the chart above.

We counted just over 25 million people who are actively contributing to a pension scheme, split roughly 70 / 30 between defined contribution (18.2m including our estimate of 1.5m people paying into an individual personal scheme as their only pension) and defined benefit schemes (7.1m). Just 930,000 people are active members of a corporate DB scheme, 2.4m are paying into the Local Government Pension Scheme across the UK, with a further 3.8m public sector workers paying into unfunded schemes such as the NHS, teachers, and civil service schemes. On the DC side, 11m active members are in workplace trust schemes (operated on behalf of multiple employers) with a further 5.6m in workplace contract schemes.

DB schemes dominate the asset side of the equation with just under £2 trillion in assets (nearly two thirds of the total). The unfunded public sector schemes - by definition - have no assets. The remaining £1.1tn in DC schemes is split between the fast-growing pool of workplace trust schemes (an estimated £250bn), workplace contract schemes (£350bn), and non-workplace personal pensions such as SIPPs (£550bn).

How has the penetration of pensions in the UK changed over the past 20 years?

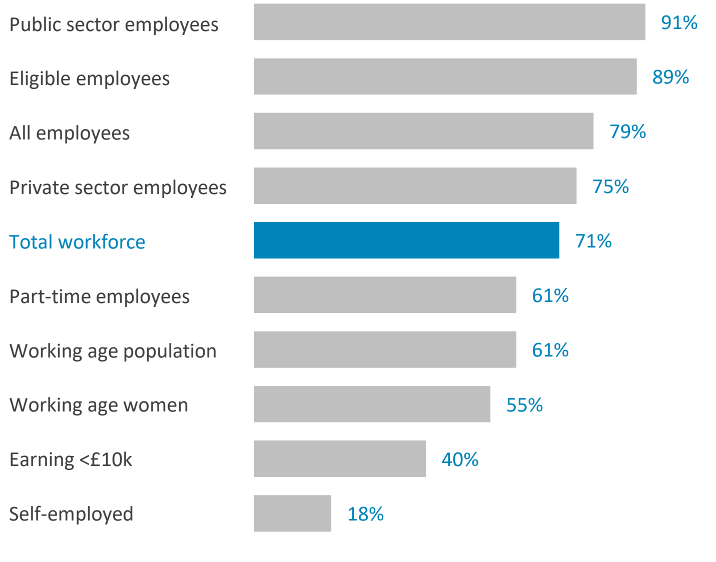
2) Proportion of UK employees participating in a pension by type of pension



Source: New Financial, ONS

3) Pensions coverage by segment of the population

% of individuals actively contributing to a workplace pension scheme (2021 or latest available data)



Source: New Financial, HMRC, ONS, TPR

One of the undoubted success stories in UK public policy over the past few decades has been the introduction of auto-enrolment pensions from 2012, which has significantly boosted participation in pensions across the workforce. As of 2021, 79% of employees in the UK were participating in a pension (and this is now probably above 80%). This represents an increase in pensions participation of more than two thirds over the past decade (from 46% in 2011) with more than 10m extra people brought into pension saving.

While the headline participation rate looks great, it disguises a wide range in coverage for different segments of the population. This is storing up trouble for the future both in terms of pensions adequacy (whether people will have enough money for a comfortable retirement) and social concerns around inequality between 'haves' (older or public sector workers with DB schemes) and 'have nots' (younger people in the private sector reliant on DC schemes or self-employed workers).

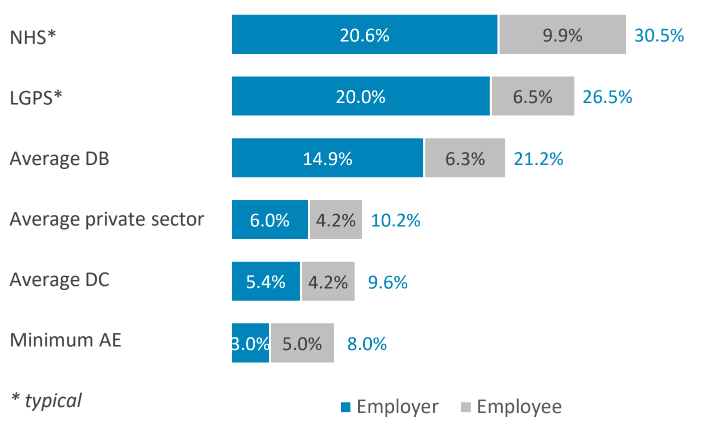
Overall, we estimate that 29% of the total UK workforce - and 39% of the working age population - are not participating in a pension scheme. That represents 10m and 16m people respectively. The participation rate ranges from over 90% of public sector workers to 61% of part-time employees, 55% of working-age women, 40% of people earning less than £10,000 a year, and less than a fifth of the 4.3m people in the UK who are self-employed.

How much are individuals and their employers contributing to their pension?

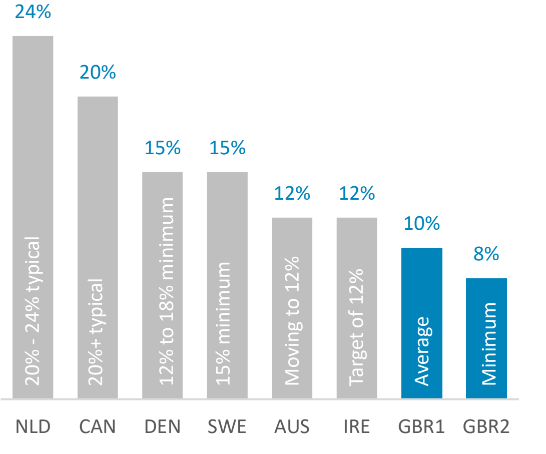
The biggest single lever that can be pulled to increase the value of a future pension is the contributions paid into it over time - and contributions are not high enough to ensure a comfortable retirement for the majority of people in the UK. The required contribution rate of 8% of eligible earnings under auto-enrolment (5% by the employee and 3% by the employer) is a lot better than not having a pension at all. However, it is significantly lower than the average rate in the private sector of around 10% (which itself is distorted by a small number of individuals in DB schemes with an average contribution rate of over 20%).

It is also unusually weighted towards the employee: in most DB schemes and other markets the employer pays at least as much as the employee, and often twice as much. While high contributions rates in unfunded public sector schemes such as the NHS are not a realistic target, it is striking to see that they are nearly four times higher than the required level for most private sector employees (and three times higher in the funded public sector LGPS schemes).

4) Selected contribution rates in the UK



5) An international comparison of contribution rates



Source: New Financial research, IFS, PPI, OECD

£120bn Employer & employee contributions to pensions in 2021-2022

£75bn Employer, employee & individual contributions to funded pension schemes

- Defined benefit: £37bn
- Defined contribution: £26bn
- Personal pensions: £12bn

£45bn Employer & employee contributions to unfunded public sector pension schemes

International comparisons on pension contributions are hard given the differences between different systems. However, the average and required levels of contributions in the UK are significantly lower than in comparable markets. In Canada and the Netherlands, typical contribution rates are above 20%; in Denmark and Sweden the minimum is 15%; while Australia and Ireland are moving their DC contribution rates to 12%. In all other markets, employers pay more than employees (and in Australia employers pay the whole minimum contribution).

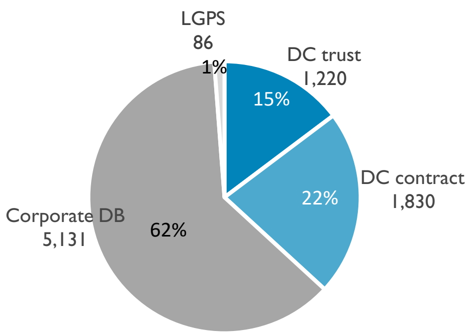
These contributions add up: total contributions to funded DB, DC, and personal pensions last year were an eye-popping £75bn. Increasing contributions would not only significantly improve future outcomes for millions of individuals across the UK but would lead to more capital flows to invest in the UK and overseas markets every year.

How fragmented is the UK pensions landscape?

The UK pension system is an unusually complex and fragmented patchwork of roughly 34,000 different schemes. The small scale of most schemes increases their unit costs, limits their investment horizons, and typically leads to worse outcomes for members. The landscape is dominated by nearly 26,000 'micro DC' schemes with fewer than 12 members but they account for a tiny proportion of assets and members. However, that still leaves around 8,200 corporate DB schemes and DC schemes (which seems like at least 8,000 too many). There has been plenty of consolidation over the past decade with the total number of schemes falling by nearly 30% However, there is plenty of scope to significantly accelerate the consolidation of pensions.

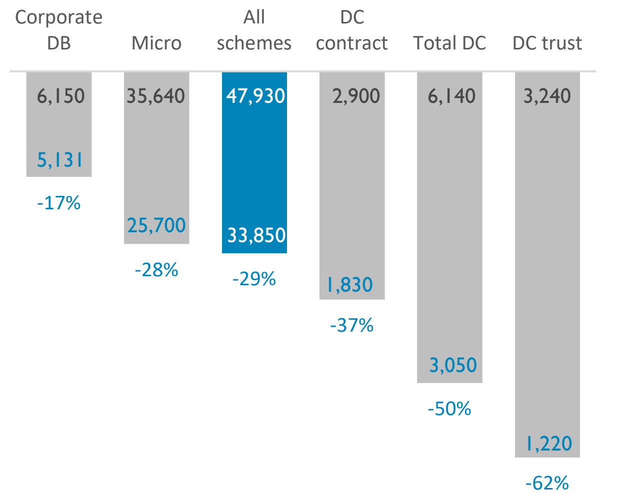
6) The distribution of pension schemes by number

(in 2022, excluding 26,000 micro-DC schemes)



7) Consolidation of UK pension schemes in the past decade

Change in number of pension schemes by type from 2013 to 2022

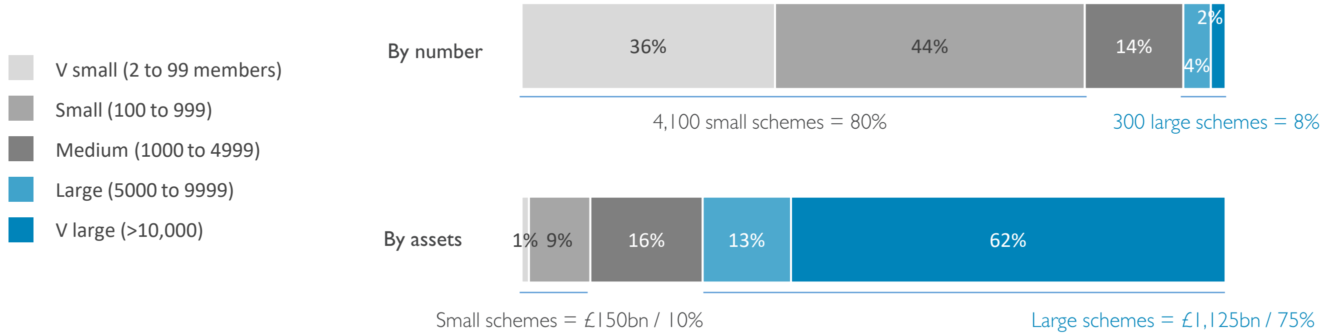


Source: New Financial estimates, TPR, PPF, FCA, LGPS

8) A question of scale

The high level of fragmentation means that most pension schemes in the UK are sub-scale. The average corporate DB pension scheme has assets of just £300m and nearly three quarters of them have less than £100m. The average DC scheme has assets of around £200m. This distribution is very lopsided: the 300 or so largest corporate schemes by number of members account for 8% of all DB schemes but 75% of DB assets. These big schemes have an average size of around £4bn, while the 35 or so master DC trusts have an average of more than £3bn in assets. This lack of scale increases costs and inefficiencies, and narrows the schemes' investment horizons. For reference, the average size of Dutch pension schemes is about £7.5bn and the average Australian super is about £10bn.

Distribution of DB schemes by number of members



Source: New Financial research, TPR

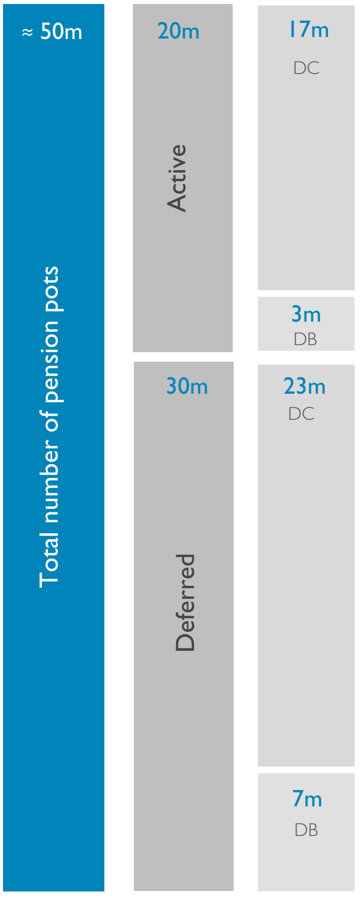
How many individual pension pots are there in the UK?

The fragmentation and complexity of the UK pensions system is compounded by the proliferation of individual pension pots. We estimate that there are around 50 million individual pension pots split between roughly 20m 'active' pots (to which people are contributing) and about 30m 'deferred' pots (where people have stopped contributing and / or have moved jobs). Defined contribution pension pots account for around 85% (17m) of the active pots and three quarters of the deferred pots (23m), giving a total of 40m DC pension pots. This may well be a few million out in either direction: while the data on trust-based schemes is consistent, in the absence of official data on contract-based DC schemes we have assumed that there is one deferred pot for each of the 5.6m active pots.

While DB pots (3m active and 7m deferred across corporate DB and LGPS schemes) are inherently difficult to consolidate, that still leaves around 40m DC pots that are ripe for consolidation. And this underestimates the overall number of pots as we have not included non-workplace personal pensions such as SIPPs. In the latest available data, 3.6m people contributed to an individual personal pension in the 2021 tax year, and there are potentially multiples of that number of inactive pots into which people have not paid money recently.

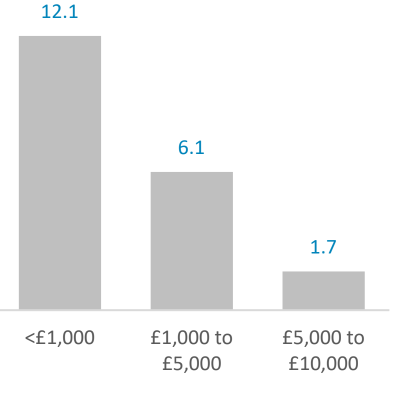
This proliferation of pots undermines future outcomes for individuals: the unit costs on smaller pots can be high (and the costs on older pots on policies started a few decades ago are often much higher). They can be costly to track and often get lost: there are roughly 2.8m 'orphan pots' worth a combined £27bn where the beneficiary is not known, according to the ABI.

9) An estimate of the number of pension pots in the UK



Source: New Financial research, DWP, ABI, PPI

10) The distribution of small deferred pots by size



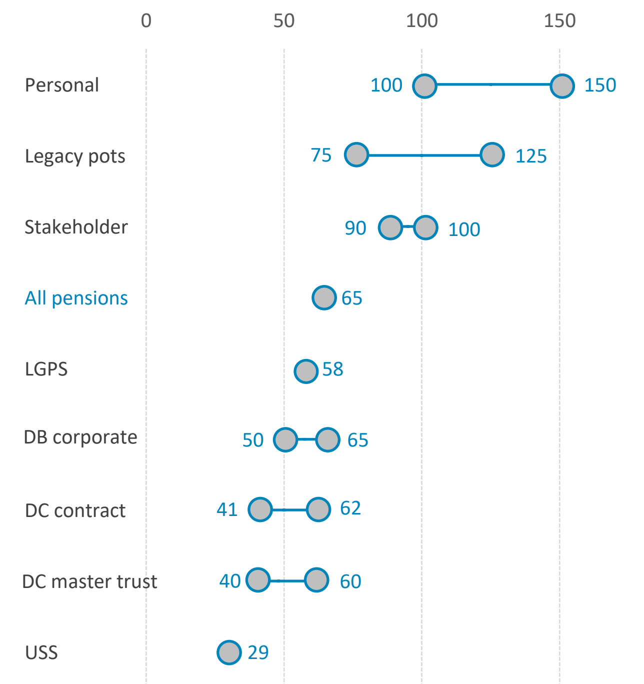
2.8m Number of 'orphan' pension pots worth an estimated £27bn

11 Average number of jobs UK workers can expect to have over the course of their career

50% Proportion of people with a pension who already have more than one pension pot

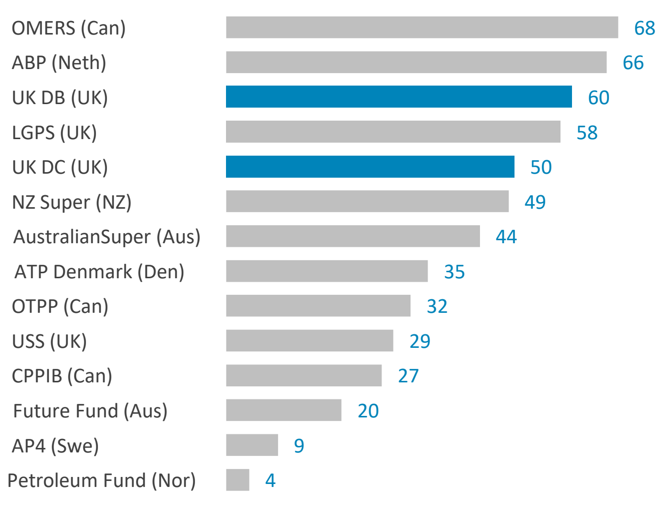
How much do UK pensions cost?

11) Estimated total annual costs for UK pensions (in basis points)



Source: New Financial, DWP, FCA

12) An international comparison
Annual costs at selected pension schemes around the world in basis points



Source: New Financial research

Much of the debate on UK pensions over the past few years has focused on how consolidation can reduce costs and improve outcomes for individuals. We think it should focus more on value.

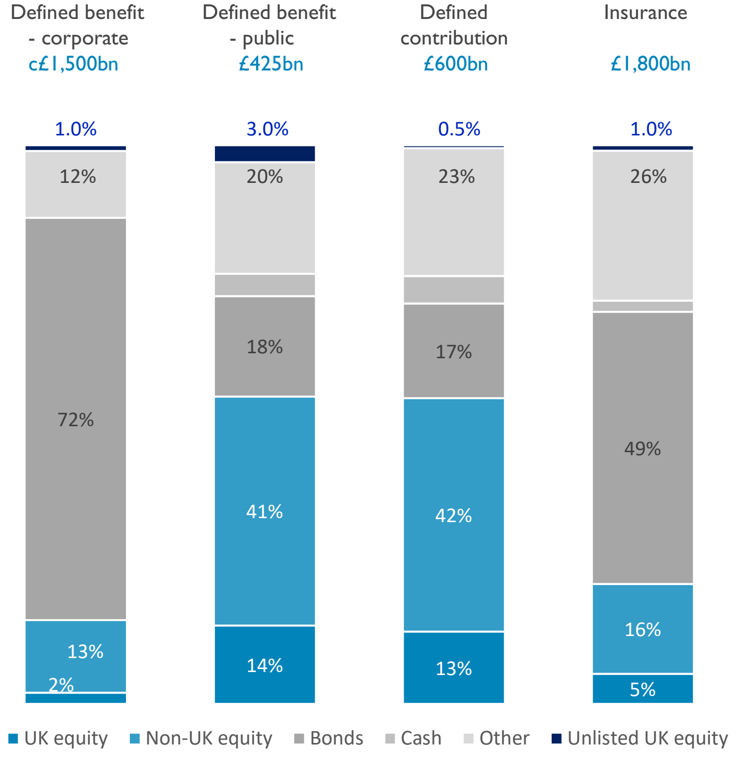
There is a wide range of costs across different types of schemes, from an average of 100 to 150 basis points (1.0% to 1.5%) for personal pensions to an average of just 48bps for DC master trusts, the main vehicle for auto-enrolment - well below the official charge cap of 75bps. It is clear that costs have dropped sharply: costs on older schemes taken out in the 1990s or 2000s are roughly double the levels on new schemes. It is also clear that larger schemes tend to have lower costs: the annual running costs at USS, a single DB scheme with £89bn of assets, are half the annual cost of running the 86 LGPS schemes in England and Wales. The Pensions Regulator estimates that costs per member for schemes with less than 100 members are five times higher than for schemes with more than 5,000 members.

However, the focus on costs has morphed into a focus on 'cost at all costs' with less focus on value and net performance after costs. The problem is that in the competition to win business, many pensions have focused on reducing costs as an end in itself (more often than not company HR departments choose pensions providers based on the lowest cost rather than on the best value). Even if they wanted to invest more in unlisted growth companies or infrastructure, many schemes fear that higher fees would increase their headline costs too much - regardless of any potential diversification or performance benefits.

Paradoxically, this leaves the UK system in the worst of both worlds: the fragmented and sub-scale structure of UK pensions means that costs are middle of the pack on an international comparison but those costs are restricting their asset allocation and performance. And the scale of many of the larger schemes in markets like Canada, Denmark, and Sweden enables them to have a much broader asset allocation - often with higher returns - at a much lower cost.

13) A detailed picture of asset allocation

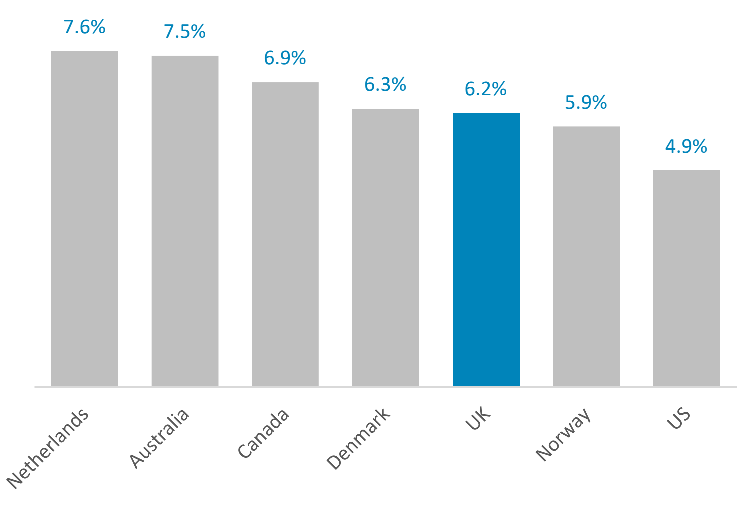
Estimated asset allocation of different types of pension in the UK



Source: New Financial, ONS, LGPS Advisory Board, PPF, Willis Towers Watson, UBS

14) An international comparison of performance

Average annualised returns from 2010 to 2020 in selected markets



Source: OECD

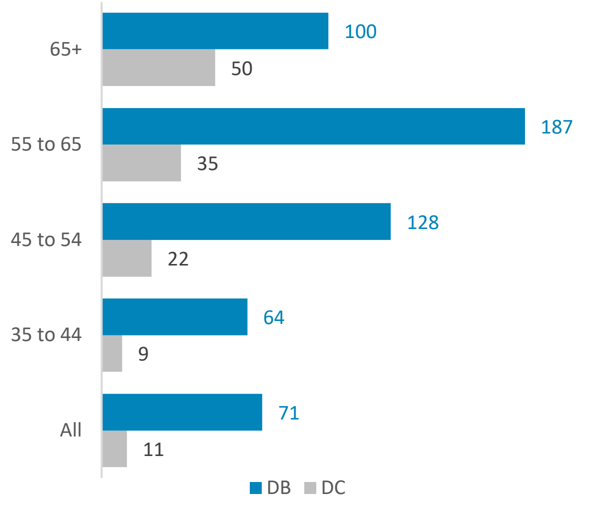
Different types of pensions have a wide range in asset allocation that is largely a rational response to the regulatory and competitive framework in which they operate. However, the pendulum may have swung too far: in aggregate UK pensions have a lower allocation to equities and alternatives, and a higher allocation to fixed income, than their international peers.

Private sector defined benefit schemes - the largest single bucket of UK pensions - allocate just 15% to equities and 2% to UK equities, which reflects the mature status of most of these schemes. But the fast-growing defined contribution sector and public sector DB schemes have a very different risk appetite and a much higher allocation to equities (and to UK equities). They each have 55% of their assets in equities, with around a quarter of that in UK equities. The bad news is that both of these 'buckets' are relatively small (at about £400bn to £600bn each) and highly fragmented (there are 86 different funds in the £370bn local government pensions schemes) and more than 3,000 DC schemes.

The challenges facing UK pensions would matter less if they were knocking the lights out in terms of performance for their members. But UK pensions appear to be firmly in the bottom half of the pack when it comes to their performance, according to data from the OECD (which we think should be treated with a degree of caution given the difficulty in comparing pension funds and systems in different countries). The average for the UK is 6.2% a year, some way behind the Netherlands, Australia, and Canada, but ahead of Norway and the US (where the figure of 4.9% looks odd). There are three common features of better performing markets: much bigger schemes, much higher contributions, and a much bigger allocation to equities and alternative assets.

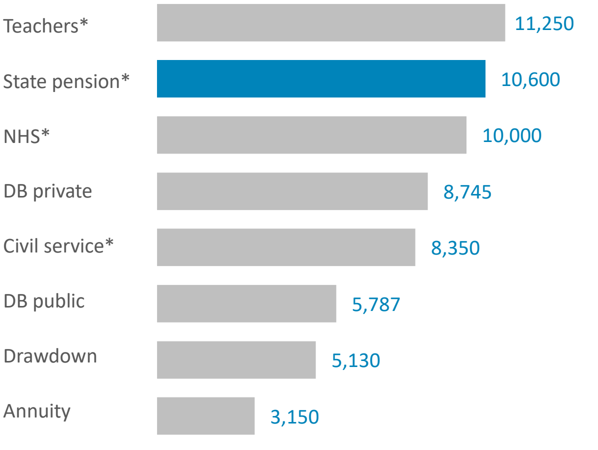
What is the outlook for millions of individuals in their retirement?

15) Median value of pension pot by age
(£'000, 2020)



Source: ONS, New Financial

16) Average annual pensions payments in different schemes
(£, 2022)
Note: these payments are over and above the state pension, shown in blue



** Unfunded schemes*

A looming problem

The combined impact of the complex and fragmented structure of UK pensions, low participation rates in some parts of the population, low contributions, a focus on costs at all costs, and conservative asset allocation is storing up trouble for millions of individuals in the next few decades in the form of inadequate pensions in their retirement. This is likely to lead to social tensions and widening inequality between the 'haves' (older or public sector workers with more generous DB pensions) and the 'have nots' (younger workers relying on DC pensions). This problem will be exacerbated by increased life expectancy, stagnating real incomes, the rising costs of long-term care, lower home ownership rates for younger people, and a falling dependency ratio of workers to pensioners.

The gap in the coming decades is already clear. The median pension pot value for people aged 55 to 65 lucky enough to have a DB pension is £187,000 - more than five times bigger than the £35,000 for people relying on a DC scheme. That translates into a pension income of around £9,400 a year in the DB scheme - but just £1,750 in the DC scheme. Workers in their twenties and thirties may still have time to build up an adequate pension pot - particularly if the industry is consolidated and contributions increase - but it is probably too late for people in their forties and fifties.

This gap between 'haves' and 'have nots' is stark in the average pension incomes across different types of scheme. Pensioners in unfunded public sector schemes such as the teachers and NHS schemes had an average pensions income of over £10,000 last year (on top of the state pension), and members of private sector DB schemes had an average income of £8,750. However, the average pension income for people who have taken out annuities (£3,150) or drawdown products (£5,150) from their DC schemes is just a third to a half of that level. To put things in perspective, at current interest rates (which have flattered pension incomes recently but are unlikely to stay high in perpetuity) an annual guaranteed pension income in retirement of £10,000 requires a pension pot of roughly £200,000. The median pension pot for all retired workers with a pension is £124,000; for employees with a pension it is £78,000; for self-employed workers who have a pension (and most don't) it is £35,000 - and for people with a DC pot is it just £11,000. Getting these numbers up to something resembling a comfortable pension in retirement is an urgent challenge.

The crisis in UK capital markets

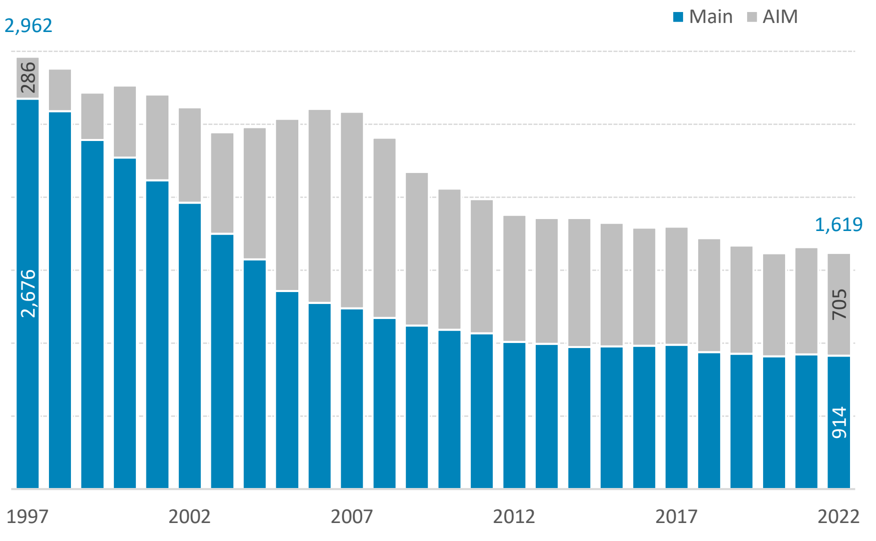
While the UK has among the largest and deepest capital markets in Europe it has been losing ground on a global level and - as with many developed economies - its public equity markets have been in structural decline for the past few decades. However, some elements of this shift are specific to the UK and we think this decline has reached a crisis point.

This section analyses the shrinkage in UK equity markets over the past 25 years and what has been driving it; the dramatic shift in the asset allocation of UK investors over the past few decades; and the growing reliance on non-UK investment in key sectors such as biotech, early-stage growth companies, and critical infrastructure.

What has happened to the UK stock market over the past 25 years?

17) Number of UK companies listed on the London Stock Exchange (1997 to 2022)

One of the biggest challenges for the stock market over the past few decades is that the number of UK listed companies has been shrinking fast: the total number of listed companies has dropped by 45% (a net loss of 1,343 companies). The Main Market has been hit particularly hard, with a fall of 66% since 1997 (although the rate of decline has slowed dramatically in the past 10 years). To be fair, this is not a UK specific problem: the number of listed companies in many developed markets (including the US) has fallen by 40% to 50% over the same period.



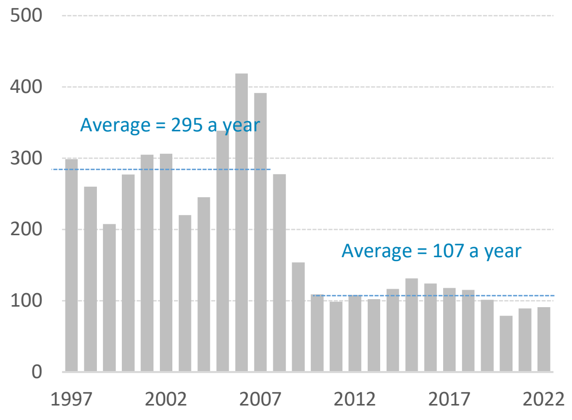
-45% Decline in number of UK listed companies since 1997

1,343 Net loss of listed UK companies since 1997

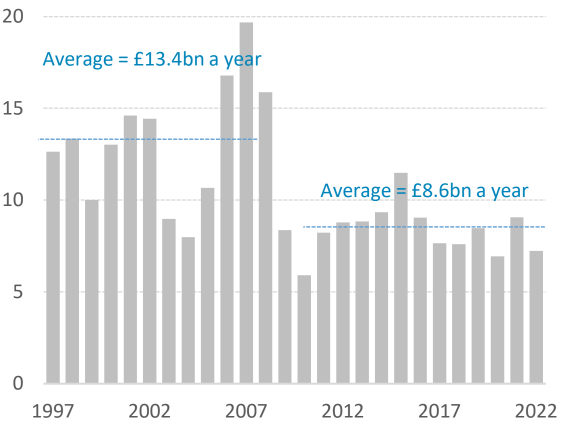
18) The UK new issue market

The number of new issues - a crude measure of the attractiveness of public equity markets - has fallen by nearly two thirds since 1997 from an average of around 300 to just 100 per year (mainly driven by a decline in activity on AIM and by smaller companies). The value of money raised by new issues has dropped by more than a third in real terms over the same period from over £13bn a year before the financial crisis to £8.6bn a year over the past decade.

X) Number of new issues by UK companies
1997 to 2022, three year rolling average



X) Value of new issues by UK companies
1997 to 2022, £bn real, three year rolling average

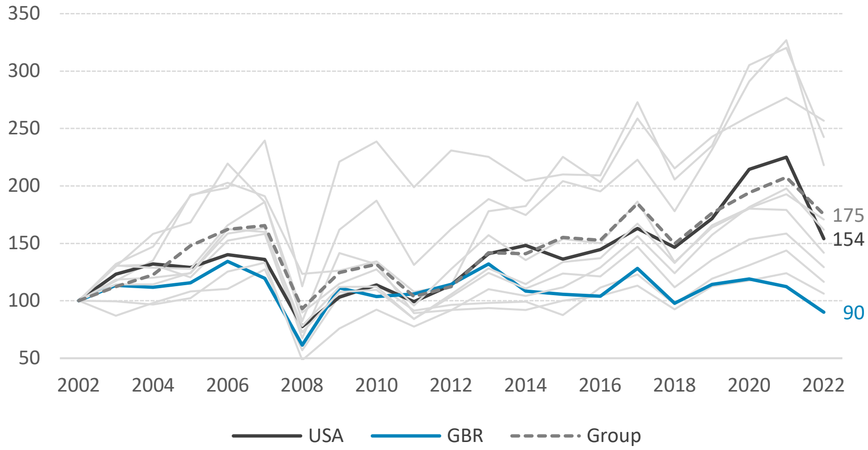


Source: New Financial analysis of data from LSEG

What has happened to the UK stock market over the past 25 years?

19) Value of companies listed on comparable stock markets relative to GDP (rebased to 2002 = 100)

What does appear to be a UK-specific problem is that the value of the UK stock market relative to GDP has declined over the past 20 years. The UK is the only developed equity market to have shrunk relative to GDP over this period (from 104% of GDP to 94% of GDP): the depth of the US market has increased by more than half to 156% of GDP and a group of comparable economies has increased by three quarters.



-10 % points — Decline in the value of the stock market as a % of GDP since 1997

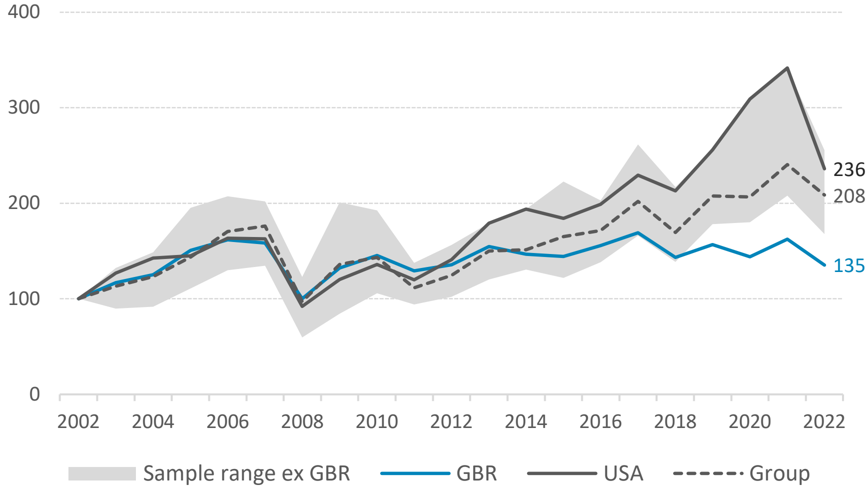
£1.8tn — How much more the UK market would be worth if it had kept up with the US since 2002

Source: New Financial analysis of data from World Bank and exchanges

** Group = Australia, Canada, France, Japan, Switzerland*

20) Value of companies listed on comparable stock markets in real terms (2002 to 2022, rebased to 2002 = 100)

Another UK-specific problem is that the combined value of UK listed companies has stagnated in real terms. Adjusted for inflation, the value of UK listed companies at the end of 2012 was £2.56 trillion - exactly the same as at the end of last year. In real terms, the UK market has grown by just 35% since 2002, the lowest growth of any comparable market. Over the same period, the value in real terms of US listed companies and of listed companies in a group of comparable economies has more than doubled (using local currencies and inflation rates).



0% — Increase in value of UK listed companies since 2012 in real terms

67% — Increase in value of US listed companies since 2012 in real terms

Source: New Financial analysis of data from OECD, World Bank and exchanges

** Group = Australia, Canada, France, Japan, Switzerland*

The valuation of the UK stock market

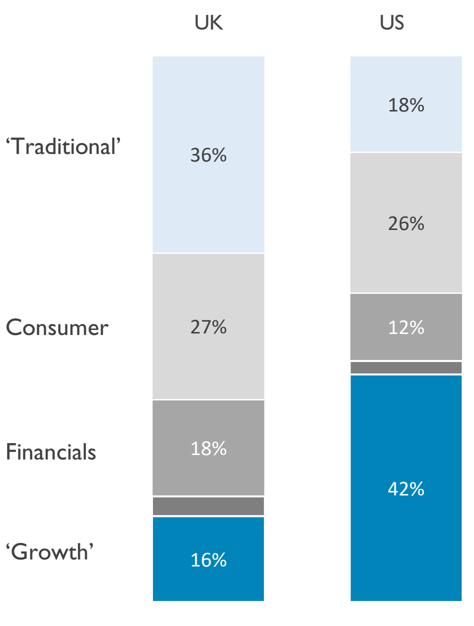
21) The composition and valuation of the UK stock market

A big part of the problem is that the UK market is dominated by traditional sectors: based on a simplified taxonomy, nearly two thirds of the UK market by value is ‘traditional’ companies (including industrials, energy, mining, and utilities) and consumer stocks (food, retail, leisure and media). The UK effectively missed out on the boom in tech companies over the past 20 years since the dotcom crash. Just 16% is from companies in what could be described as ‘growth’ sectors (biotech, life sciences, and technology), compared with 42% for the US. This probably underestimates the gap as large US ‘growth’ companies like Amazon and Tesla (worth about 5% of the US between them) are counted under ‘consumer’ stocks.

The composition of the market helps explain the FTSE 100’s valuation discount of 46% with the S&P500. There is a significant discount across most sectors of the market, showing that not all of the discount is down to the difference in composition. Some of this reflects the unique premium that the US market attracts from international investors, although the UK also trades at a smaller discount to European markets (of around 5% on the same basis).

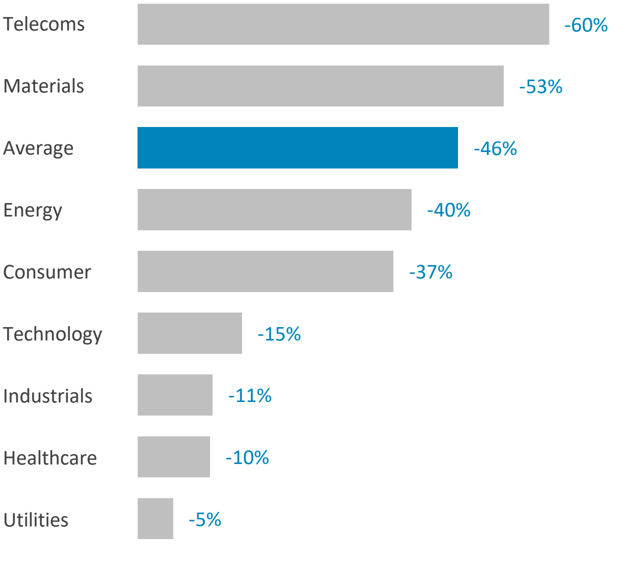
A big factor in the discount with the US is that forecast earnings growth for US companies is significantly higher than for UK listed companies, suggesting that investors are less confident of the wider economic outlook for the UK and for UK listed companies. This also suggests that moving a listing from London to New York is not a miracle cure for UK companies that are unhappy with their valuation unless they can also demonstrate improved growth prospects. The recent performance of UK companies that have listed in the US such as Amgen, Arrival, Babylon, and Cazoo shows that the grass is not always greener in the US market.

22) Composition of UK and US stock market (2022)



23) Valuation discount between FTSE 100 & S&P 500

Discount based on price / earnings ratio (as of June 2023)

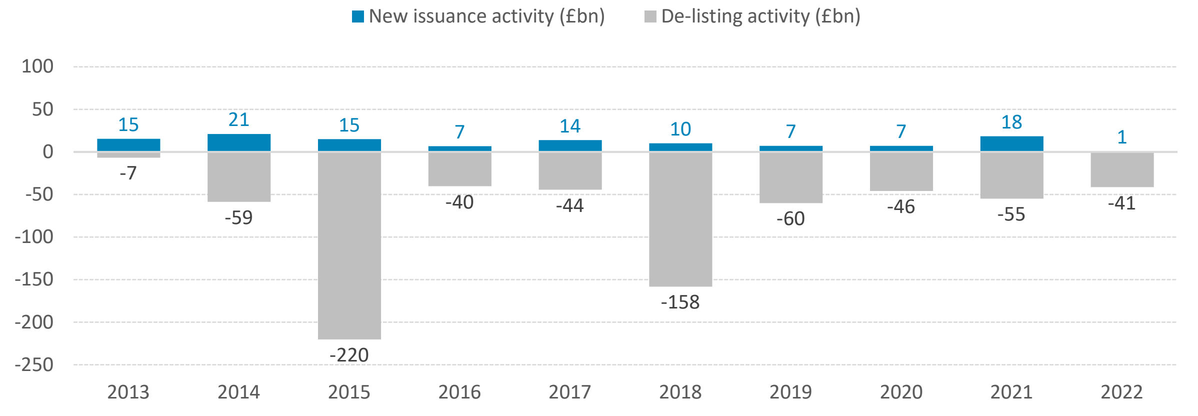


Source: Citi, New Financial analysis of data from LSEG and S&P

What has happened to UK listed companies over the past decade?

24) Value of new issues and de-listings / take privates on the LSE (2013 to 2022, real £bn)

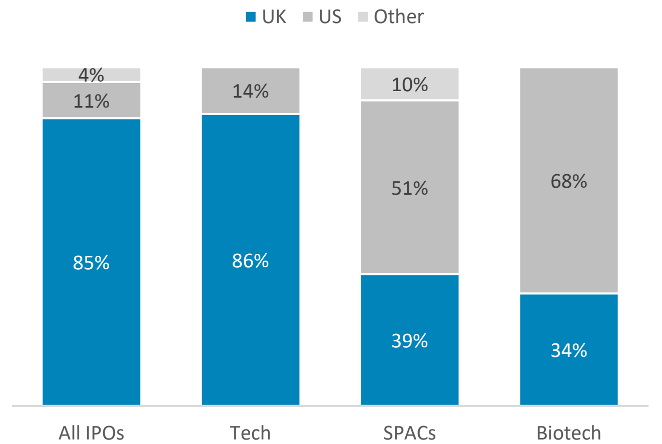
UK listed companies are leaving the stock market faster than they can be replaced. Over the past decade more than 1,000 UK companies have raised around £120bn in real terms in new issues - but this has been offset more than six times over by more than £700bn in de-listings (mainly through the acquisition of listed companies by private or overseas firms). Over the past decade, an average of 125 UK companies a year have delisted from the stock market (more than two a week) and there have been more delistings than new listings in 17 of the past 25 years.



Source: New Financial analysis of data from Dealogic and LSEG

25) The listing destination for UK IPOs (2013 to 2022)

Much of the concern about the UK stock market has focused on companies moving their listings to the US (such as CRH or Ferguson) or tech and biotech companies choosing to list in New York rather than London (such as ARM, Immunocore, or Vaccitech). It is important to maintain some perspective: for all the noise, we have identified just five companies that have moved their listing over the past decade from London to New York, and 85% of IPOs by UK companies by value (and 86% of tech companies) have taken place in London. However, more than two thirds of the IPOs by UK biotech companies over the past decade have been done in the US.



16 Number of UK biotech or healthcare firms that have IPOed in the US in the past 10 years

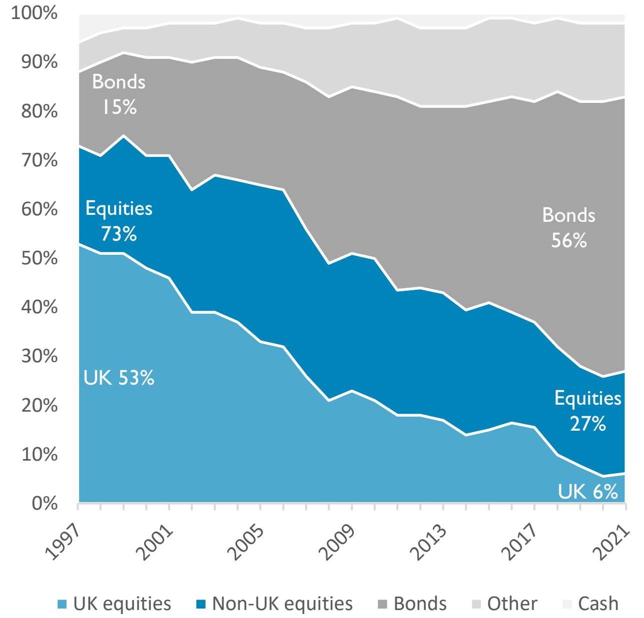
$2.6bn Combined value of IPOs in the US by UK biotech or healthcare firms

Source: New Financial analysis of Dealogic data

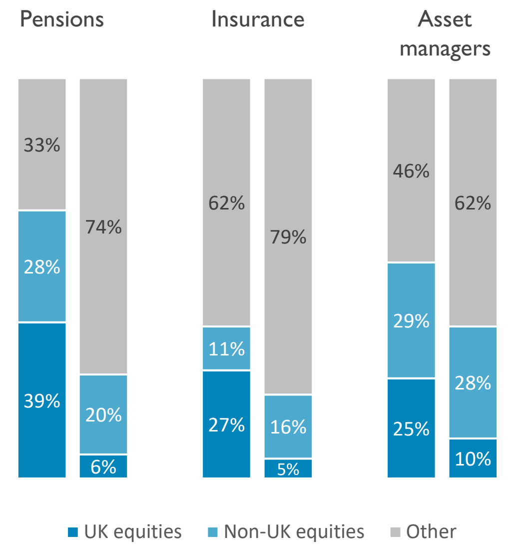
Falling behind

A comparison of the headline asset allocation of UK pensions with the global average over 25 years

26) Headline asset allocation of UK pensions
1997 to 2021



27) Shift in asset allocation by UK institutional investors
2002 to 2021



Source: New Financial, ONS, LGPS Advisory Board, PPF, Willis Towers Watson, UBS

Capitalism without UK capital

Over the past 25 years there has been a breathtaking shift in risk appetite and asset allocation of UK pensions. The charts above show the headline asset allocation between equities and bonds from 1997 to 2021 in the UK (on the left) and the headline shift by UK pensions, insurance companies and asset managers over a similar period (on the right).

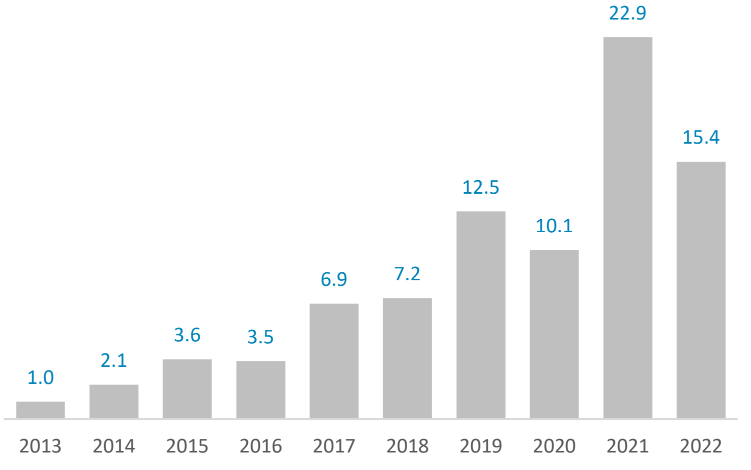
To be clear: this is the aggregate shift in asset allocation across all types of pensions, and largely reflects the change in the maturity and status of corporate DB schemes (the largest component of UK pensions) and the regulatory framework around them. The smaller segments of LGPS and DC pensions have a much higher allocation to equities (nearly 60%) but the data highlights the problem with the UK effectively killing off private sector DB schemes before having something ready to replace them at scale.

Over the past few decades the aggregate allocation to UK equities has fallen from 53% to just 6%, sucking a huge amount of natural demand out of the UK equity market. This is a faster rate of decline than the two thirds drop in the overall allocation to equities, suggesting that UK pensions have become more internationally diversified in the outlook (good) and that there may be something specifically wrong with the attractiveness of the UK equity market (not so good). Over the same period, the allocation by UK to bonds nearly quadrupled to 56%. The UK system now has the lowest allocation to equities and the highest allocation to fixed income of any of the seven largest comparable pensions systems. This shift has also been apparent among insurance companies (who have cut their UK equity exposure by 80%) and UK-based asset managers (where it has more than halved). It is worth noting that UK retail investors have nearly halved their allocation to UK equities over the past decade (from 32% to 18%) despite maintaining broadly flat exposure to equities overall, according to our research.

What has happened in early-stage investment in UK growth companies over the past decade?

28) Value of early-stage investment in UK companies (2013 to 2022, real £bn)

In a rare outbreak of good news in UK capital markets, the value of early-stage and venture capital investment in UK companies has soared in the past few years. Over the past decade, £85bn in real terms has been invested in UK growth companies (close to the £90bn raised in the IPO market) and more than three quarters of that has come in the last five years. However, there has been a sharp slowdown in investment this year and we expect to see between £7bn and £9bn in investment this year.



94% Value of early-stage deals as a % of value of IPOs over the past 10 years

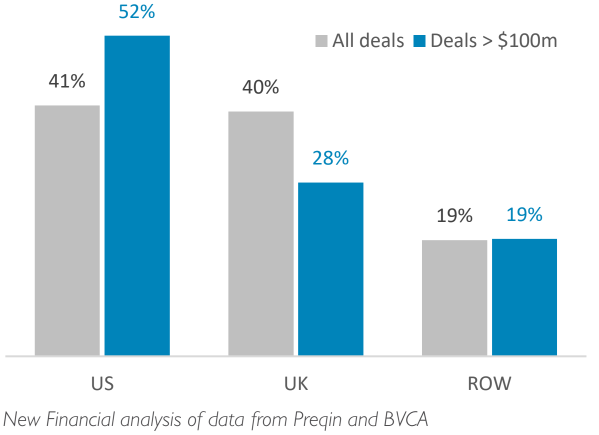
4,000 Number of UK companies backed by early-stage investment over the past decade

Source: Preqin

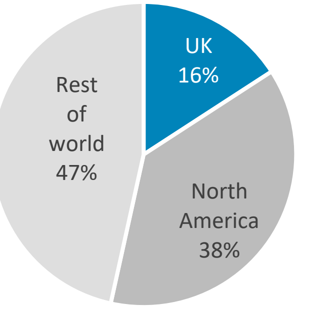
29) Source of investment in venture capital and private equity

While the increase in venture capital investment is welcome, one potential concern is that most of that investment comes from overseas. We estimate that 60% of all venture capital investment in the UK is by non-UK firms - and this share increases to over 70% on larger investments over $100m. There is nothing wrong with international capital, so long as it is a genuine choice and not the only available option. It is also striking that UK investors represent just 16% of the value of venture capital, growth, and buyout funds raised by UK firms in the five years from 2017 to 2021 (and UK pensions and insurance companies accounted for just 3% of the money raised by UK funds).

i) Source of early-stage investment in the UK (2013 to 2022)
2013 to 2022, by nationality of investor

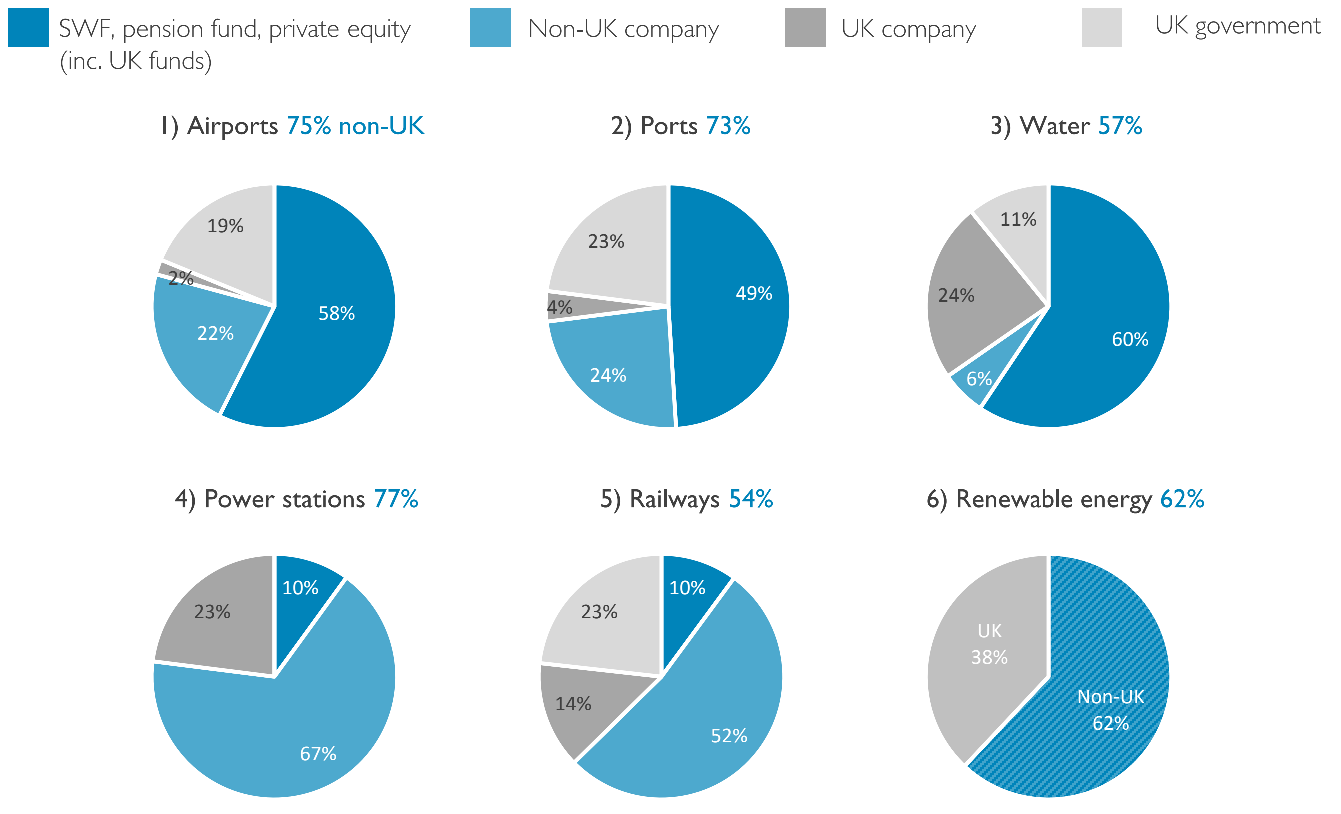


ii) Source of fundraising by UK VC & buyout firms
2017 to 2021, by nationality of investor



Source: New Financial analysis of data from Preqin and BVCA

30) Ownership of critical infrastructure in the UK



Source: New Financial analysis of public data and company documents

Notes: 1) Airports - top 20 airports by passenger numbers 2) Ports - top 10 ports by tonnage 3) Water - all water companies in the UK 4) Power stations - top 20 power stations by generating capacity 5) Railways - rail operators by passenger numbers 6) Renewables - BEIS database of renewable energy capacity in the UK.

Concrete investment

One of the many paradoxes in UK capital markets is that a country with more than £5 trillion in pools of long-term capital in the form of pensions and insurance assets has effectively outsourced much of the investment in its critical infrastructure to sovereign wealth funds, Australian and Canadian pension funds, and private equity firms.

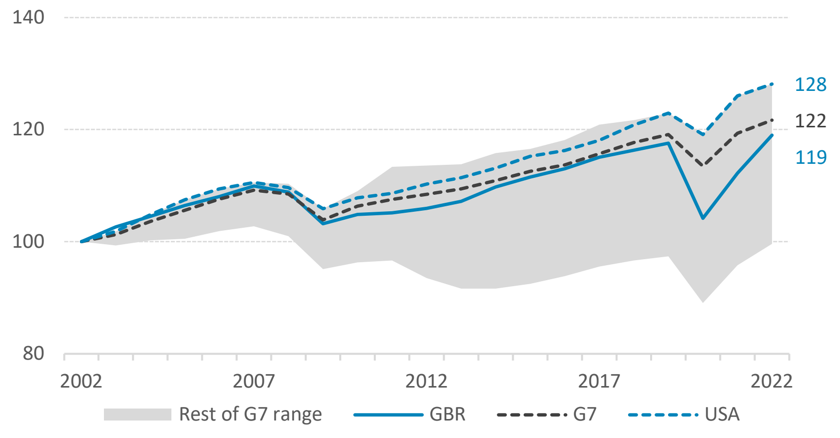
Our analysis of the ownership of key assets in six different sectors shows that on average over 60% of these assets by capacity are owned and / or operated by non-UK financial investors or non-UK companies. This ranges from three quarters of the UK's airports, ports and power stations to over half of its renewable energy capacity, water companies and rail operators.

While the UK is rightly open to international investment, it may be the case that the pendulum has swung too far. Setting aside the potential national security implications, this situation raises several issues. First, non-UK owners (and particularly non-UK financial investors) may have less of a connection to UK assets. Second, the economic benefits of owning these assets are flowing to non-UK investors rather than to UK investors. And third, the high level of interest by non-UK investors in these assets underlines the relative lack of investment by UK investors in this sector (USS owns part of Thames Water and Heathrow, and Federated Hermes owns part of Thames Water and Eurostar). If they are so attractive to SWFs and pension funds from other countries, it suggests that it is structural issues rather than attractive returns that are holding back their UK counterparts.

What has happened to UK growth and productivity over the past few decades?

31) Growth in real GDP per capita (2002 to 2022)

The slowdown in capital markets activity and investment activity in the UK is a contributing factor to sluggish growth. Over the past few decades there have been three distinct phases in real GDP per capita growth in the UK. In the decade before the financial crisis the UK was in line with US and G7 level of growth. In the decade after it began to fall behind, and since the Covid pandemic and Brexit growth in the UK has dropped away sharply.



2.3% Annualised growth in UK real GDP per capita from 1996 to 2007

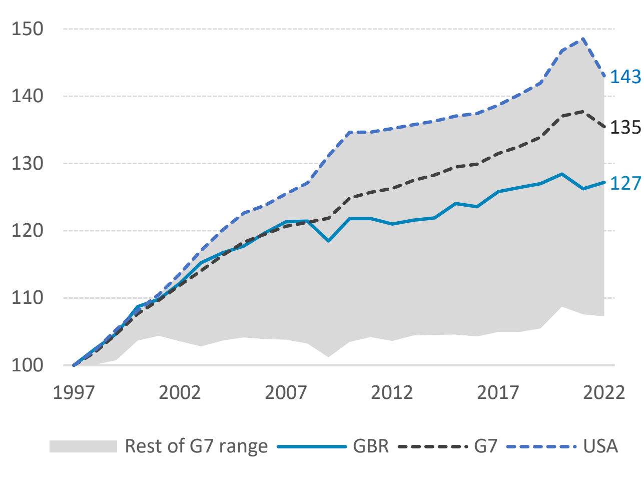
1.0% Annualised growth in UK real GDP per capita since 2010

Source: New Financial, OECD

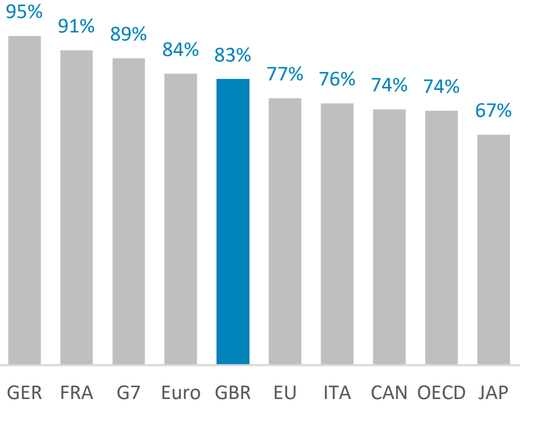
32) Productivity

One of the main drivers of increase in real GDP per capita is productivity growth (generating more output from the same inputs). On this measure, the UK dropped behind the US five years before the financial crisis, fell behind the G7 average shortly after the crisis - and has struggled ever since. In the decade before the crisis, UK productivity in real terms grew at an average of 2% a year but has since fallen to just 0.3%. UK output per hour worked is just 83% of US levels today, compared with 93% back in 1997.

i) Growth in productivity (1997 to 2022)



ii) Output per hour relative to the US economy
2022

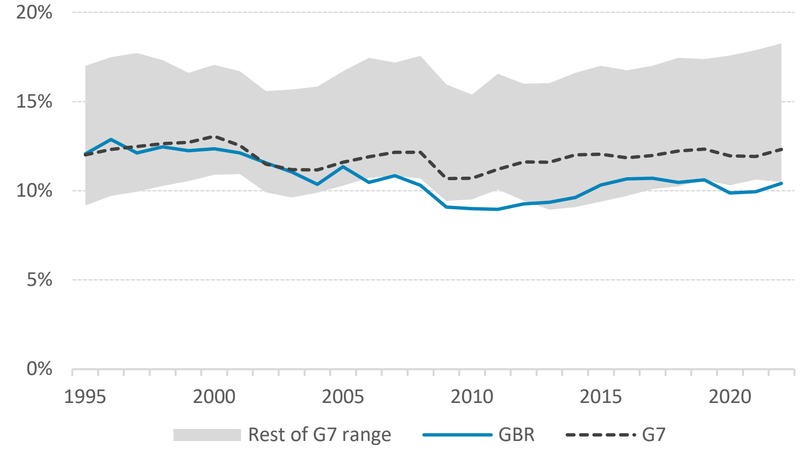


Source: New Financial, OECD

What has happened investment by UK companies over the past few decades?

33) Gross fixed capital formation by corporates (1995 to 2022, % of GDP)

The UK economy needs all the help it can in the wake a series of economic shocks, and a good place to start is by investing its way to growth. However, the UK has the lowest level of corporate investment in the G7 (as measured by gross fixed capital formation as a % of GDP) and has been in this position for most of the past 15 years. Investment is little more than half the level of Japan, a third less than France and below the EU average. When you look at all investment across the economy (including by government and by households) the UK has consistently had the lowest level of any G7 member since the mid-1990s.



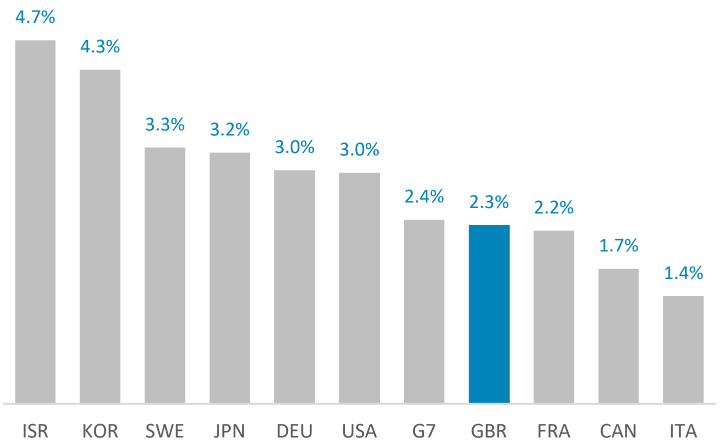
11.7% Average UK corporate investment as % of GDP from 1995 to 2007

9.9% Average UK corporate investment as % of GDP from 2009 to 2022

34) Investment in R&D

The UK has 'towards the back of the pack' levels of investment in R&D - the sort of investment that can have a big impact on productivity growth and real GDP per capita growth. In the 10 years to 2021 total R&D averaged 2.3% of GDP in the UK - roughly a quarter lower than the US, Germany and Japan - and way behind markets like Israel and Korea. In fairness, R&D is one area where the UK has been catching up: in the decade before the financial crisis UK R&D was just 1.6% of GDP, roughly 40% lower than in the US.

R&D investment as a % of GDP (2012 to 2021)



2.3% R&D as a % of UK GDP over the past decade

1.6% R&D as a % of UK GDP in the decade before the financial crisis

Source: New Financial, OECD

Fixing the problem

The parallel crisis in UK pensions and capital markets has been brewing for years: it is time to stop admiring the problem and start fixing it.

This section outlines a series of proposals and recommendations across pensions, capital markets, and the wider economy that could help rebuild a virtuous circle of investment and growth in the UK. It also includes a snap summary of some comparable pensions markets around the world, and an outline of some behavioural and cultural changes that will also be required.

WHAT CAN WE LEARN FROM OTHER PENSION SYSTEMS?

The right model

The UK is not the first country to rethink its pensions system: there are many highly-developed pensions markets around the world that could help point the UK in the right direction. In the recent debate, the Australian 'super' system and the 'Canadian model' have been widely cited as part of the solution. You cannot simply copy and paste the system from one country to another, but there are different elements of each system that could be applied to reforms in the UK. In an ideal world, the UK might pursue the 'super' structure and asset allocation of the Australian system for DC pensions, the 'Canadian model' for public sector DB, the pension pot portability of the US system, and the focus on scale and efficiency of pension systems in Denmark, Sweden, and the Netherlands.

Australia

160% of GDP

The Australian 'super' system has been widely cited as a potential model for DC schemes in the UK. Introduced in the early 1990s, it is a DC system with a mandatory minimum contribution by employers of 11% (soon to be 12%). There are over 120 not-for-profit superfunds with an average of £10bn in assets each into which workers are defaulted by their employer. Half of all assets are in 26 much bigger industry-wide supers. Three quarters of assets are invested in equities and alternatives. On the downside, the system provides a low replacement income in retirement, has lower participation and higher fees than the UK, and there are high levels of pensioner poverty.

Canada

180%

The 'Canadian model' is often seen as a template for pensions reform, based around a small number of big schemes like the CPPIB (£335bn) and province-backed funds such as Ontario Teachers (£150bn) or Omers (£75bn). The public sector DB schemes (a third of all pensions assets) have a high allocation to private markets, infrastructure, and alternatives. However, occupational pensions coverage in the private sector is low (at around 37%) and falling and the system is fragmented (with 15,000+ schemes). The 'Canadian model' would only really apply to the UK for public sector DB schemes (such as LGPS or, in future, unfunded schemes such as the NHS).

Denmark

250%

Danish pensions are larger relative to GDP than in any other country. The system is over 100 years old but was overhauled in the late 1980s. The largest Danish fund ATP acts as supplementary fund for basic pensions, and over 90% of the workforce is covered by a quasi-mandatory system that has migrated from DB to DC since the financial crisis. The system is dominated by multi-employer schemes and life insurance companies (with over 99% of assets), and the largest eight schemes account for almost 40% of all assets. Contributions range from 10% to 18% and the target replacement income is 80% of median earnings.

Netherlands

200%

The Dutch system is in transition. Over the past 20 years it has adopted conditional indexation (where the future increases in benefits are dependent on the funding of the scheme), switched from final salary to career average, and most recently to a collective defined contribution system with 'pension expectations' rather than guarantees. It is dominated by a small number of huge industry-wide schemes - the 8 largest schemes represent around 60% of assets - and is a model of consolidation: the number of schemes has fallen from over 1,000 to around 200 over the past 25 years. The collective nature of the new system could form part of a future model for the UK.

Sweden

121%

Sweden has been switching to a funded model over the past 25 years across its basic and occupational pensions. Half of Swedish pensions assets are in a semi-funded pillar 1 system with high employer and employee contributions (of over 17% combined) which is allocated to the seven large AP Fonden. Occupational pensions are quasi-mandatory and are dominated by four large schemes managed by a small number of big providers such as Alecta (which has around £100bn of assets). Tax benefits on personal pensions have been abolished except for the self-employed.

USA

190%

The US system is dominated by 401(k) DC schemes and personal pensions such as IRAs (Individual Retirement Accounts). It is a more individualistic system with lower levels of coverage. The main benefit of the system is the portability of pension pots, with many people shifting their 401(k) pots into their IRA as they move jobs. The individual nature of the system helps explain the much higher level of engagement in investment in the US. However, the system is heavily skewed and most people's pension pots are relatively small: the median IRA pot is worth about $40,000, and median 401(k) pots are less than $1,000 (as less than half of workers have one).

The importance of non-regulatory reform

Many of the challenges facing pensions and capital markets are not regulatory in nature and therefore cannot be solved by reform of regulation. Before diving into our proposals for regulatory reforms, here is a selection of non-regulatory and cultural reforms that will play a vital role in driving change:

1. **A new risk culture:** one of the biggest challenges ahead is to encourage a renewed appetite for risk and a new 'risk culture' across the market - from policymakers and regulators, to pensions schemes, trustees, companies, entrepreneurs, and individual investors. This risk aversion was accelerated by the financial crisis 15 years ago and permeates every corner of the industry from the top down (and nowhere more so than in pensions where the focus has been to eliminate risk and offload schemes). For many individuals, investment equals risk and risk equals losing money with little thought for the returns side of the equation. The danger is that too many investors have been protected from risk and loss almost to the point of exclusion. There are signs that this is changing: the FCA's recently reforms to the listings regime explicitly said that the reforms involved a transfer of risk to investors but there is a long way to go in convincing politicians, regulators, the industry, the media, and individuals that an appropriate level of risk is an essential element of thriving pensions and capital markets - and a thriving economy.

2. **The industry mindset:** no single sector of the capital markets industry that can solve this problem on its own. Instead, the industry will have to work together to develop a more joined up and more connected ecosystem. If the industry wants the UK to have bigger and better capital markets, it needs to be better at making the case for why strong capital markets matter, particularly at a time when millions of people in the UK are far more worried about paying their bills than they are about the future of the City. A good place to start is for the industry to stop talking about itself in self-referential terms and instead focus on how it can drive investment in growth and prosperity for millions of individuals in every corner of the UK.

3. **Political engagement:** this in turn will help drive wider political engagement. A growing number of politicians across the political spectrum recognise the urgency of pensions and capital markets reform. But there are at least two big political challenges for the industry: first, how to persuade politicians who have half an eye on an election in the next 18 months to spend some of their limited political capital on reforms for which they will receive no electoral benefit. And second, how to turn this into 'retail politics' and frame it in more accessible terms for millions of voters: why should my mother and her local MP care? As a bonus, the issue of pensions and investment has nothing to do with Brexit, which should encourage a less charged debate.

4. **A concerted campaign:** a concerted information, education, and financial literacy campaign on pensions, investment, and capital markets targeted at every level of government and at individuals in every corner of the UK would help drive awareness and engagement. This could be provided by government, financial services firms, and employers. Given that DC pensions require individuals to shoulder more of the risk of their future pension, it is vital that more individuals have a better understanding of the basic principles. The industry can play a big part by using plain and simple language in its marketing material and communications.

5. **Nudge, nudge:** behavioural economics can play a significant role to nudge people into making better decisions. For example, savers could receive an automated and tailored nudge to think about their investment options if their income or bank balance goes above a particular level. An automated system of online 'financial health checks' could encourage people to think about their finances after receiving a nudge from government or their employer at particular life stages (leaving school or university, starting a new job, buying or renting a house, having kids etc). And communications around people's pensions could be communicated in more accessible terms (such as the Australian approach of using cultural and lifestyle references) to help people appreciate their likely income in retirement.

Unpicking the 'nastiest and hardest problem in finance'

Reforming pensions should be an urgent priority in its own right to help ensure a more comfortable retirement for millions of UK citizens - and it's an essential part of rebooting UK capital markets. Here is a selection of proposals for reforming UK pensions that build on the Mansion House reforms and that we have divided into three groups: i) short-term / relatively 'easy' reforms ii) medium term / harder options; and iii) longer term / more radical options.

>>> Short-term / relatively easy:

There is no such thing as an 'easy' option in pensions reform but we think there at least four areas where the government can push ahead in the short-term. In most cases they involve building on work that is has already been done or is underway, and where there is a broad consensus of the need for change.

- **1) Increasing contributions:** the biggest single lever that can be pulled to increase the value of a future pension is the contribution rate paid into it over time - and contributions today are simply not high enough to ensure a comfortable retirement for the majority of people in the UK. The required contribution rate of 8% of eligible earnings under auto-enrolment (5% by the employee and 3% by the employer) is a lot better than not having a pension at all - but it is significantly lower than international comparisons (where 12% to 18% is typical), defined benefit contributions (around 21%), and lower than the target contributions of 15% that many pension experts think is the minimum for a secure retirement. While it would be difficult to mandate higher contributions in the current economic climate, the UK could follow the glidepath outlined by the ABI to gradually raise contributions to 12% over the next decade (and ideally 15% in the longer term). This could be encouraged by corporation tax relief for companies that make higher contributions. More investment in assets like infrastructure, renewable energy, and growth companies would encourage people to feel they are making a difference with their pension and would likely drive more engagement.

- **2) Widening participation:** despite the remarkable success of auto-enrolment over the past decade in widening participation in pensions there are still significant gaps, particularly among part-time, lower paid, younger, or self-employed workers. The government should accelerate the passage of a private member's bill that recently passed the first hurdle in parliament to reduce the age for auto-enrolment from 22 to 18 and reduce the earnings threshold on which pension contributions are paid from £6,240 a year to zero. Ideally, it would legislate to remove the main remaining barrier to auto-enrolment: that it is only triggered for employees earning more than £10,000. Less than a fifth of self-employed workers are contributing to a pension. That is their individual right but their fellow citizens will have to pick up some of the bill for that decision in future. The government could explore a staggered increase in NI contributions for self-employed workers over time and allocating those payments to a default pension scheme such as Nest.

- **3) Rethinking risk and regulation:** the cumulative effect of layers of well-intended pensions reforms over the past few decades has effectively eliminated a sense of risk and growth in pensions and its wider system, creating what you might call a culture and supply chain of risk aversion. To be fair, pension funds and insurers have not so much lost their risk appetite as had it kicked it out of them. This has prompted companies to close their pension schemes, and in turn encouraged those schemes to reduce risk and volatility. The government should launch a Hill / Kalifa / Austin / Flint-style review of the cumulative impact of pension reforms to re-assess the objectives, duties and liabilities of pension fund sponsors, trustees, regulators and consultants.. Pension fund sponsors and trustees could have broader objectives to ensure that asset allocation is likely to result in real growth and meet pension commitments over time. This could include more focus on longer-term net investment returns and less focus on cost minimisation and risk eradication. And The Pensions Regulator's objectives could be reviewed to ensure economic growth, long-term prosperity, and outcomes for individuals saving for their pensions are explicitly included.

- **4) Pension pot consolidation:** a big challenge with the growth in DC pensions that the UK system doesn't have a robust mechanism to address the proliferation of small pension pots (we estimate that there are at least 40 million DC pensions pots today, excluding millions more SIPPs). The government should build on the work done by the industry and Work and Pensions Committee to introduce an automatic 'pot follows member' system for DC pensions when people move jobs unless they opt-out. This would also help address the problem of legacy pots from older schemes which often have an inappropriate asset allocation and much higher costs than current schemes. The US model of IRAs (individual retirement accounts) could provide a template, and bigger / more consolidated pots are likely to drive more engagement with people's pensions.

>>> Medium-term / harder

With an election on the horizon the political bandwidth to address more complex challenges in UK pensions may be limited, but here are selection of proposals for this and future governments to develop over the next five years:

- **5) Turner 2.0:** pensions reform is complex and the sort of structural reforms needed to improve the UK pension system go beyond party politics and electoral cycles. They require a long-term commitment across the political spectrum to develop the best possible framework in the long-term interest of individuals, companies, the economy, and government finances. The UK is not the first country to rethink its pensions system and a common theme in many markets that are often held up as examples to follow is that they thought long and hard about reform and deliberately worked to gather cross-party political support. There is a strong case to build on the latest proposals and set up a new independent pensions commission to follow the successful Turner Report from 2004 to 2006, review the progress of auto-enrolment a decade on, and help design a UK pension system fit for the next 50 years based on the essential building blocks of successful comparable systems.

- **6) Regulation and data:** the complexity of the UK pension system is matched by the complexity of its regulatory structure. The Pensions Regulator oversees corporate defined benefit schemes and LGPS (around £1.9 trillion in assets), and the trust side of defined contributions (about £250bn+). The FCA regulates the contract side of defined contributions (roughly £350bn) as well as individual pensions (perhaps another £550bn+). And the PRA supervises insurance companies providing bulk annuities (over £350bn and rising) which provide pensions for nearly two million people. At a government level, the 'P in DWP' (pensions) sits in the Department of Work and Pensions, overlapping with HM Treasury, and HMRC. Each body produces their own data in a different way. Much of the official data on pensions from the ONS is incomplete (by nearly £1 trillion) because it excludes individual pensions and workplace contract pensions, as is most data on the number of pension pots and the number of individuals saving for a pension. Consolidating regulation would, reduce costs, concentrate expertise, significantly improve pensions policy, enable faster and more effective reform, and hugely improve the quality and consistency of data in such an important area.

- **7) Consolidating DB pensions:** in the past few years, it has been tempting to focus on DB pensions as the main source of additional investment in UK assets because that's where the money is. Consolidating the highly-fragmented corporate DB pensions market with more than 5,100 schemes and around £1.5tn in assets has often been touted as miracle cure that would unleash a flood of money back into UK equities, infrastructure, and unlisted equities. The evidence that bigger schemes generate higher returns is inconclusive but improving the efficiency of these schemes would be a public good in itself. Voluntary consolidation of corporate DB pension schemes through superfunds or the PPF (as envisaged under the Mansion House reforms) would reduce costs, complexity, and rent seeking; reduce pressure on scheme sponsors; and improve the funding status of schemes. However, under the current regulatory framework and industry mindset there is limited incentive or scope to unlock a wall of money.

- Most of the money from corporate DB schemes that used to be invested in UK equities has gone and isn't coming back: 90% of schemes are closed to new members, and around 80% all DB pensions assets are in mature schemes that are closed to new members or new benefit accrual. Schemes have responded entirely rationally to reforms by shifting their investments to less volatile assets to match their future liabilities, and little will change without a shift in thinking in government and regulators about the extent to which DB schemes that have decades still to run should eliminate risk. Even within these constraints, we estimate that there is an addressable market of up to £300bn in DB pensions assets that are primarily servicing deferred members (people who have not yet retired) and which could be suitable for adopting a broader asset allocation. This may help unlock a significant increase in asset allocation to listed and unlisted equities and to other productive assets like infrastructure. if you assume that 10% to 20% of this pool of 'addressable' assets is reallocated, this could mean a shift in investment of roughly £30bn to £60bn.

- This shift could be helped on its way with a new regulatory regime for voluntary consolidation through DB superfunds outlined in the Mansion House reforms. While there has been lots of interest in superfunds there has been limited appetite so far: there is just one authorised superfund provider and it has yet to complete a deal. A better option for voluntary consolidation would be to develop a framework to enable smaller schemes or those that are unlikely to reach the level of funding required for a buyout to fold themselves into a revised version of the PPF alongside its existing mandate as a pensions lifeboat. While this is unlikely to unlock a wall of money into UK listed equities (the PPF's allocation to all listed equities is just 6%) it could encourage billions of pounds into private capital and infrastructure debt.

- **8) Pension buyouts:** given that the entire DB pensions system is designed to incentivise companies to close and offload their pension schemes, it makes sense to accept that roughly half of corporate DB schemes today will likely be bought out in the coming decade. Around 1,000 or so schemes are sufficiently well-funded today to be bought out (under which the whole scheme is insured, wound up, and members transferred as individual policyholders to an insurance firm). The government should focus on ensuring that more of this capital can be put to work in more productive ways: reforms to Solvency II should actively encourage and incentivise insurance companies to allocate a significant proportion of these assets (perhaps a quarter) to socially-useful real assets like housing, infrastructure, and renewable energy. At current rates of buyouts, that translates into about £12.5bn of investment a year.

>>> Longer-term / more radical

It is entirely up to this and future governments how radical they want to be with pensions reform. While the above measures would improve outcomes for millions of individuals and enable UK pensions to invest in a broader range of assets, they are unlikely to lead to a revolution, in how the pensions industry works and what it invests in, or a revolution in UK capital markets Here are some longer term and more radical suggestions:

- **9) A universal pension and investment account:** pensions are as integral a feature of people's lives as work and taxes. Most people over the course of their lives will accumulate a host of different pensions and investment accounts, from multiple DC pension pots, legacy DB pensions, ISAs, investment accounts, and their state pension. One way to address this complexity (and to short-circuit work on consolidating pension pots) would be to create a universal pensions and investment account for every individual in the UK that could act as a single flexible vehicle for their pensions and investments over the course of their life. Individual products and pension pots from different providers would automatically link to these accounts, which in turn would be linked to people's NI numbers (or future digital IDs) so that they never actually have to open a new pensions or investment account. Ideally, these accounts could be issued a birth (potentially seeded with an initial investment of £1,000 or more to get people going - this would cost about £700m a year).

- **10) A 'super trust' model for DC pensions:** as the market has evolved over the past few decades it has become hugely fragmented: there are nearly 29,000 separate schemes and even if you strip out 25,000 micro-schemes with a handful of members each - you are left with over 3,000 separate DC schemes with average assets of just £200m each. Consolidation is already underway: over the past decade the number of DC schemes (excluding micro-schemes) has halved, and the government is accelerating its 'value for money' initiative. However, the UK could be much more radical and aim in the long-term to adopt something like the Australia super system (where the 126 schemes have average assets each of around £10bn) or the stark simplicity of the Danish or Swedish systems.

- Master trusts (multi-employer schemes) are heading in this direction: in the past decade the number of master trusts has fallen from over 80 to around 35 and they have average assets of around £3bn. A realistic long-term target might be 20 master trusts, with the remaining 3,000 DC schemes encouraged, nudged, incentivised - and eventually required - to fold into them. Assuming DC pensions assets will hit something like £1.25 trillion in assets in the next decade, this would create a series of 20 'super trusts' with around £50bn+ in assets each. Economies of scale, wider investment horizons, and increased professionalisation would enable these 'super trusts' to invest in a far broader range of assets in the long-term interest of their members at a significantly lower cost than today - with lower volatility and higher returns than they currently deliver (the average five-year annualised real return for a selection of large master trusts is just 2.1%, according to research by LCP).

- **11) Local Government Pension Scheme:** the proposed acceleration of pooling the assets of the £370bn LGPS scheme is welcome and will create a series of eight large asset pools with an average of around £40bn each. However, it misses an opportunity to go further and consolidate the 86 administering authorities that sit behind the individual schemes and are responsible for asset allocation decisions that overwhelmingly drive returns. Each of these authorities has its own councillor-led investment committees, governance arrangements, processes, and advisers, creating an additional layer of cost and complexity.

- Collapsing these authorities into a handful of schemes (or even a single body, maybe called the Local Government Investment Authority), combining them with the asset pools, and introducing arms-length in-house management would create a globally-significant pension scheme along the lines of the Canadian model. This would also generate around £1bn in cost savings a year (assuming costs fell from their current level of 58 basis points to the CPPIB's 27bps) and enable the scheme to invest at scale and the long-term in a far wider range of assets. Assuming 4% real returns, these costs savings would add up to £45bn over 25 years.

- **12) Reforming unfunded public sector schemes:** the most radical and potentially most powerful long-term solution would be to reform the huge unfunded public sector schemes such as the NHS, teachers, and civil service schemes - which have liabilities of over £2 trillion but no assets. In order to have an expansive asset allocation, pensions need to have a deep pool of active members, and there are four million people making contributions to these schemes today. The government already sits behind these schemes (their liabilities are already included in the UK's whole government accounts) but they do not sit on the government's balance sheet. The government could bring them on to its balance sheet and replace their guarantees with non-marketable gilts, creating a series of giant funded schemes overnight. Over time, these could be swapped into marketable gilts allowing the schemes to diversify into other asset classes.

- At the same, the schemes could adopt a staggered approach to switching the £45bn a year in notional employer and employee contributions to these schemes to a funded model, perhaps over 10 years. In year one, 10% of contributions would go into a fund, in year two 20%, and so on. These contributions are currently used to pay public sector pensions, and the shortfall in the medium term could be funded by reducing the £25bn a year in tax relief on pension contributions for higher and additional rate taxpayers.

A high-quality problem

While the headline numbers on UK capital markets look pretty grim, the UK has a very high-quality problem: it has all the right building blocks in place to build bigger and better capital markets. The key challenge is to work out how to better join up the dots and build on these existing strengths. The UK has the second largest pool of long-term capital in the world after the US with around £5 trillion in pensions and insurance assets, and a further £1 trillion or so in retail investment assets. It has a strong regulatory regime; a high concentration of financial markets expertise and talent; the largest stock market in Europe; and is the biggest international financial centre after the US.

On the other side of the equation, the UK has world class universities; a strong track record of scientific research and innovation; more unicorns than any market apart from the US, China, and India; and a global leadership role in sectors like fintech and life sciences. For good measure, there is a unique window of opportunity for change with a rare alignment in the political, regulatory, and industry appetite to reform UK capital markets. A full analysis of capital markets reform is beyond the scope of this report but here is a selection of thematic proposals to build on the work that has already been done and accelerate the development of bigger and better capital markets in the UK:

>>> **Beyond the Edinburgh Reforms:** the Edinburgh Reforms package outlined last year was a good starting point: a broadly sensible collection of proposed reforms across capital markets, covering everything from listings and equity research, to the tax regime for UK investment funds and disclosure regime for derivatives trading. The government should push ahead with these reforms but there is opportunity to build and improve upon them. Now that the Financial Services & Markets Act has been passed, the process of reform can be speeded up with a shortened timeline for consultations and reviews.

A frequent critique from the industry is that the reform process so far has been too much of a 'shopping list': it is now crucial to step back, see the bigger picture, and develop a clearer strategy focused on a small number of core themes that run through different sectors of the industry (such as the need to rebuild a risk culture). This process will require a much clearer distinction between the 'domestic' role of the industry in supporting investment in UK companies and the 'international' role of the UK as a host venue for cross-border financial markets activity to avoid 'fuzzy' policy decisions. And it will require a better set of 'warts and all' metrics based on outcomes and a better dashboard to map the UK's progress against clearly stated aims and against its international peers

>>> **Widening retail participation:** much of the debate on 'unlocking capital' has focused on pensions but there is huge untapped potential in widening retail participation. Retail capital adds up to more than £1.5tn across ISAs, direct stock investing, investments in funds, and personal pensions. While retail investors need sufficient protection, they should not be protected to the point of exclusion. The number of hoops they have to jump through to access markets - and the number of hoops firms have to jump through to provide them with services - need to be streamlined, but not to the point of the unregulated free for all in cryptocurrencies over the last few years. Regulators and the industry will also need to think hard about how to incorporate wider retail participation into market structures and practices that have deliberately kept retail investors at arm's length for years.

Retail investors will also need the right vehicles to invest in a wider range of assets (such as private capital and infrastructure) from which they are largely excluded. A good example is simplifying ISAs: around 20% of households bought an ISA last year but only around one in 20 bought a stocks and shares ISA. The ISA structure could be simplified into a single product that enabled individuals to shift between cash and investments. It will also be vital to provide better access to information: the government should accelerate its work on reviewing the rules that separate guidance and advice, potentially embracing a third option of 'personalised financial guidance' to enable more people to engage with capital markets *(note: New Financial is publishing a report later this month on 'Widening retail participation in equity markets').*

>>> **Taxation:** if the UK wants more equity financing, it could take a global lead on reducing or eliminating the tax differential between debt and equity finance. In addition to abnormally low interest rates, one of the big attractions of debt finance has been the generous tax differential between debt and equity: debt finance is tax deductible, while equity financing is taxed four times. Closing this gap would make equity financing and public equity markets much more attractive and benefit individuals and the economy through the expansion of risk capital and the democratisation of wealth creation.

The UK could consider introducing exit taxes and payback clauses for companies that have benefited from government grants and tax reliefs if they chose to list overseas or move their HQ abroad. And it could consider winding back the clock to the 1980s in two key areas of taxation: first, reverting to minimum level of UK assets in an ISA (perhaps a third) to qualify for full tax relief. And second, harmonising rates of capital gains tax and income tax but reintroducing indexation to ensure that only real gains are taxable.

>>> **Governance and disclosure:** high standards of corporate governance and disclosure are a hallmark of high-quality markets but over the past 25 years there have been almost as many iterations of the UK governance code as there have been Prime Ministers. The government should review whether the corporate governance and disclosure regime for listed companies has gone too far in driving the real and perceived burden of being listed. This review could include whether the regime could be adjusted for all but the largest listed companies, brought into line with international norms and comparable markets (for example, proxy voting recommendations on issues such as pay and bonuses are different in the US and UK) and how to reduce the disclosure gap between public and private companies. Rethinking the stewardship code would could encourage investors and companies to place more emphasis on long-term growth rather than short-term investment, and to shift the industry away from its obsession with daily liquidity investment funds.

>>> **Digitisation and technology:** there is a danger that the reform process focuses too much on solving yesterday's problem and not enough on the challenges the industry is likely to face tomorrow. Embracing and enabling technology and digitisation should be a core theme running through reforms of pensions and capital markets. The government and regulators should actively promote the digitalisation and standardisation of markets and investment to reduce costs and improve transparency, push for the digitalisation of the issuance process, provide incentives to companies and investors to use digital platforms to connect issuers, banks, and investors, and encourage the development of more standardised documentation.

Digitisation should not just make existing legacy processes and structures more efficient but transform the process itself. Accelerating the work of the Digitisation Taskforce led by Sir Douglas Flint to overhaul the archaic legacy system of paper share certificates in the UK and re-establishing a direct digital link between investors and the assets they own can work as a template for reforming other corners of the market.

>>> **Regulation & supervision:** while there is a risk of adding too many mandates to UK supervisors (the UK has only just added growth and competitiveness to the mandates of the FCA and PRA) it is striking that they do not have specific mandates based on the underlying purpose of capital markets. The UK should explore expanding existing mandates of regulators and supervisors to include outcomes-based mandate such as 'facilitating capital formation' (one of the SEC's three mandates) or 'widening participation in banking and finance'.

At such a critical juncture in the reform of UK market it is imperative that government departments, supervisors, and regulators have the expertise and resources that they need. A mix of secondments from the industry, bigger budgets, increased salaries, and more training to attract and retain talent from the private sector would help ensure a higher degree of technical expertise and independence. Politicians, regulators and supervisors will also need to embrace a cultural shift away from eliminating risk and failure: this will require a degree of agility and a shift in culture at regulators, who should be granted occasional 'permission to fail'.

The bigger picture

While specific regulatory, structural and behavioural reforms to UK pensions and capital markets are important, ultimately they will achieve little unless they are accompanied by reforms in the wider economy to make the UK a more attractive investment proposition. In order to make the UK a better destination for domestic and international investment - and to enable capital markets, businesses and individuals to thrive - it will need to embrace a broader approach.

>>> **Make up your mind:** a clearer, more consistent, and more predictable industrial strategy based around a handful of strategic priorities and sectors would help create a more certain backdrop for investment. The UK needs to decide what it wants to be really good at instead of trying to boil the ocean and be 'world leading' at everything it does. Most of the challenges facing the UK go beyond party politics and electoral cycles. Investors taking a long-term view of the UK economy need greater long-term certainty on big levers such as tax incentives for investment (the UK's current regime is set to expire in three years). Government(s) should work across the political spectrum to develop a baseline of incentives on which there is long-term political agreement.

>>> **Planning reform and infrastructure:** a chronic shortage of houses and lengthy delays in the industrial and infrastructure planning process are a huge drag on growth and investment in the UK. The UK has four million fewer homes that it would have if it had kept up with European level of housebuilding per capita over the past 50 years; large-scale infrastructure projects have been stuck in consultation for decades; the UK spends around five times as much per mile on rail, tunnel and road infrastructure as comparable markets; and renewable energy projects face a wait of up to 14 years to connect to the national grid. A clear government plan with central targets and (dis)incentives for local government to embrace them would help unblock development. For reference, a target of 300,000 new homes a year translates into just 461 homes a year per constituency.

>>> **A regulatory shift:** over the past few decades the number of regulatory bodies and their powers in every corner of the economy has mushroomed. While a robust regulatory system is necessary, it is equally essential that it retains a strong focus on consumer outcomes, is responsive to change, is fully democratically accountable, avoids becoming siloed, and is benchmarked to best international practice. Post-Brexit, there is an opportunity to review and rethink the UK's regulatory system across the economy, perhaps starting with the work of the recently launched Regulatory Reform Group in Parliament.

>>> **Global Britain:** an economy like the UK that is reliant on international trade and capital flows and which positions itself as a hub for international business, needs to have an immigration system that is flexible enough to attract the best international talent, meet demands for immigration in vital services and industries, while reflecting political concerns over long-term immigration. The UK should also address the disconnect between public statements about 'Global Britain' and the practical experience of many people when they come into contact with it (such as their reception on arrival at the UK's borders or the increases in the costs of visas).

>>> **Digital first:** the UK has made great progress in terms of digital government over the past few decades but has recently lost ground to some of its more progressive peers. The UK should focus on what countries like Denmark, Korea, and Estonia have achieved in improving the efficiency of individuals' interaction with government and embracing a digital first approach to administration with a single digital ID for individuals and companies.

>>> **Cheaper energy:** the high cost of industrial and residential energy is a big drag on growth. While the UK has one of the highest levels of low-cost renewable energy among developed Western economies, energy prices are roughly double the level of the US and around a quarter higher than markets like France. Accelerating the existing review of electricity market arrangements launched in 2022 to decouple renewable prices from fossil fuel prices would significantly reduce costs for UK businesses and households and incentivise investment.

NEW FINANCIAL
Rethinking capital markets

About New Financial

New Financial is a think tank that believes Europe needs bigger and better capital markets to help drive growth and prosperity. We think this presents a huge opportunity for the industry and its customers to embrace change and rethink how capital markets work. We work with market participants and policymakers to help make a more positive and constructive case for capital markets around four main themes: rebooting UK capital markets; reforming EU capital markets; driving sustainability; and driving diversity. We are a social enterprise funded by institutional membership from different sectors of the capital markets industry.

Lead author

William Wright, founder and managing director - New Financial

William launched New Financial in 2014. He works with governments, regulators, and the industry to encourage capital markets reform, and recently presented to EU finance ministers and central bank governors at the Informal Ecofin meetings in Stockholm and Paris. He previously spent 18 years as a financial journalist as the editor and member of the launch team at Financial News, which was acquired by the *Wall Street Journal* in 2007. He was educated at Oxford, London, and INSEAD.

New Financial LLP
1 Duchess Street
London
UK, W1W 6AN
www.newfinancial.org

William Wright
Managing director
william.wright@newfinancial.org
+44 (0) 20 3743 8269

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