REVIVING UK INVESTMENT

BY **ASHOK GUPTA**

Investment into the UK economy is vital to our prosperity, to address societal inequality, to support the climate transition and fuel economic prosperity. Yet the UK investment system itself is ineffective and needs reform. The potential that actuaries have to help realign the investment system to better support society is not well understood.

This may come as a surprise to many readers, but it becomes obvious when you consider the investment system as a whole. Through that lens, the pivotal role that actuaries play in determining how investment monies are allocated becomes clear.

Understanding and improving the investment system is the challenge New Capital Consensus (NCC)[1] has set itself. NCC's evidence for the failure of the UK investment system derives from the UK having the second largest pool of investment within the OECD yet remaining one of the worst invested countries. The UK investment system is failing to channel UK savings into the UK economy.

Our work to date has focused on the UK – a complicated enough challenge! Future research is hoping to consider other countries. Clearly if these failings are true of the UK, similar factors could be affecting investment in other countries?

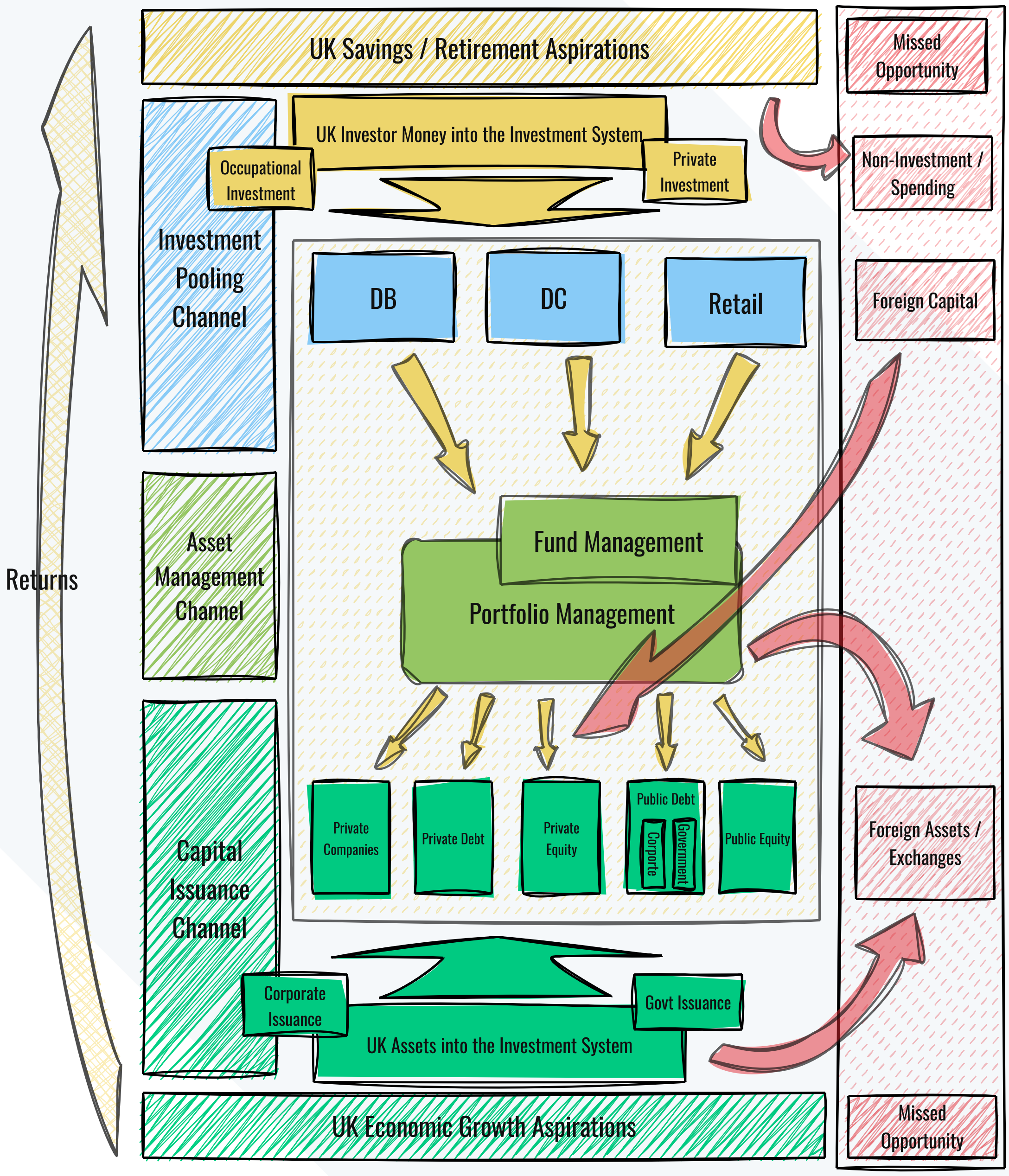
THE UK INVESTMENT SYSTEM

The origin of UK savings is the population; their savings are comprised mostly of investment for retirement and the system primarily needs to work for them. The destination for part of these savings should be the UK economy, comprised of companies who need investment capital to produce goods and services, create jobs and economic prosperity.

While trustee fiduciary duties require them to make asset allocation decisions in the interests of their stakeholders, and many argue they invest overseas to get better returns, inefficient asset allocation techniques result in few DB schemes getting the levels of return enjoyed by the large Canadian schemes. >

[1] NCC, an independent, not-for-profit, apolitical project, the result of a coalition of Chatham House Sustainability Accelerator, Leeds University, Radix (a think-tank for the radical Centre) and the IFoA's own FinSTIC (Financial Systems Thinking Innovation Center).

NCC'S VIEW OF THE UK INVESTMENT SYSTEM



The bulk of the system comprises three channels:

- the Investment Pooling Channel, which comprises DB and DC pension schemes, the Retail Investment sector plus financial advisors;
- the Security Issuance channel, which raises capital for UK companies and of course the government, through both public and private capital markets; and linking these
- the Asset Management channel, which takes pools of capital provided by asset owners and invests them utilising capital markets.

The UK investment system does not live in isolation and is connected to other UK financial systems like the banking or insurance systems and forms part of an interconnected global system, as illustrated by the column on the right.

UK SYSTEM FAILINGS

NCC's quantitative research has identified the amount of money in the system, where it resides and how it has been invested. In addition, a series of nearly >

50 interviews has been used to identify the incentives within the system and how these drive the allocation of savers' money. What has NCC's research found?

Interviewees identify that current market structures have developed in an amorphous way and do not today support the effective allocation of capital, eg the interface between the investment pooling and the asset management channel is a key point of weakness. Thousands of asset owners all feed into a very concentrated set of investment consultants and fund managers. This has led to herding behaviours, so that most investment strategies are very similar. All but the very large asset owners have insufficient agency. Structures and incentives all drive long-term money to be invested in a short-term way.

What may make sense for an individual pension scheme, such as derisking its investment strategy and developing a glide path to buy-out, makes less sense when done by the entire system and has resulted in significant loss of money from the system.

The Investment Pooling Channel comprises three distinct interconnected submarkets (DB, DC and retail and private savings), each with its own regulatory and market structure, imposing a patchwork of regulation upon the UK's pensions and savings industries. This is inefficient in terms of economic funding and creates complications for individuals whose savings are governed by multiple regulatory regimes.

The primary incentives identified are all the ones you expect - regulation, accounting, tax, risk management and market practices. These all drive a very heavy focus on cost minimisation, elimination of volatility and provision of liquidity. Given volatility and liquidity are secondary factors for long-term investors, this seems unhelpful. Public price transparency helps regulators reduce fraud, but the hunt for liquidity and short-termism is the antithesis of long-term investing. Asset managers, of course, invest according to the mandates provided by asset owners which are constrained by their regulatory risk appetites.

What is more interesting are the incentives that are absent. Bizarrely there are almost no incentives to seek returns; and limited incentives to close market gaps, such as providing decumulation solutions and low-cost advice/guidance using technology, or to account for externalities (including the future value of investment as distinct from its immediate cost).

The feedback loops identified that have developed over time are key. Many actuaries will recognise that DB accounting standards have led to short-termism in the investment mentality of DB Schemes. For those of you not familiar, the excellent report of the House of Lords Review into the Liability Driven Investment (LDI) crisis of September 2022, that severely disrupted the UK gilt market, is a must-read.

The feedback loop of most relevance to actuaries relates to risk management. The system focus on short-term volatility as a proxy for long-term investment risk has contributed to risk aversion. The system tries to eliminate short-term volatility rather than find the appropriate trade-offs between long-term, outcome-centric risks and rewards. This has contributed to UK Defined Benefit pension funds reducing their holdings in equities, which when combined with a shift to greater use of global mandates, has resulted in the UK now having one of the lowest levels of investment in its own companies across the OECD.

But perhaps the most damning criticism of the system is that its desire for liquidity disincentivises primary investment, i.e. investment by companies in their businesses to help them provide the products, services and jobs the country needs to fuel economic prosperity. >

WHAT CAN BE DONE?

The Government has already set out on the right path through its Pensions Investment Review led by a Minister that sits across the UK Governmental Department for Work and Pensions (DWP) and the UK Treasury. It is vital that this review is ambitious in its scope. NCC has set out a series of recommendations that could reorient the incentives within the system.

DB consolidation is clearly needed for private as well as public schemes. We also believe we need to change tax incentives to reflect what wrappers invest in. We need better long-term risk management measurement and mandates that reflect the needs of savers. Removing the requirement for daily liquidity in DC and retail investments will help pensions schemes to exploit their inherent ability to invest long-term. Too many mechanisms, e.g. Default fund lifestyling and buy-out guide paths, encourage pension schemes to derisk far too early, reducing investment risk at a time when investment pots are high, and risk appetites remain substantial.

Policymaking is itself a patchwork affair, the disparate elements of which (from Pensions Review to Industrial Strategy) need to be analysed as a networked whole.

Individually actuaries operate on a micro level in providing advice to clients and organisations. Collectively, as a profession, we have an obligation to consider and articulate the effects of actuarial work on society. Certainly, many of our techniques are driven by regulation, but we are consulted and engaged on these regulations and actuaries are involved in the technical details.

If we fail to speak out about the potential damaging impacts of inappropriate regulation, our reputations and that of our profession are at risk. The Profession has a voice, we need to make sure it uses it – to create a financial industry that is not failing our society but investing in it. <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ASHOK GUPTA is a Founder of New Capital Consensus, a non-profit, independent coalition of organisations set up to analyse the UK investment system and identify leverage points capable of encouraging long-term investment in societal objectives. He also has various NED roles. He has chaired an industry review of the Defined Benefit pensions sector and was joint deputy chair of a Bank of England Working Group on Procyclicality.