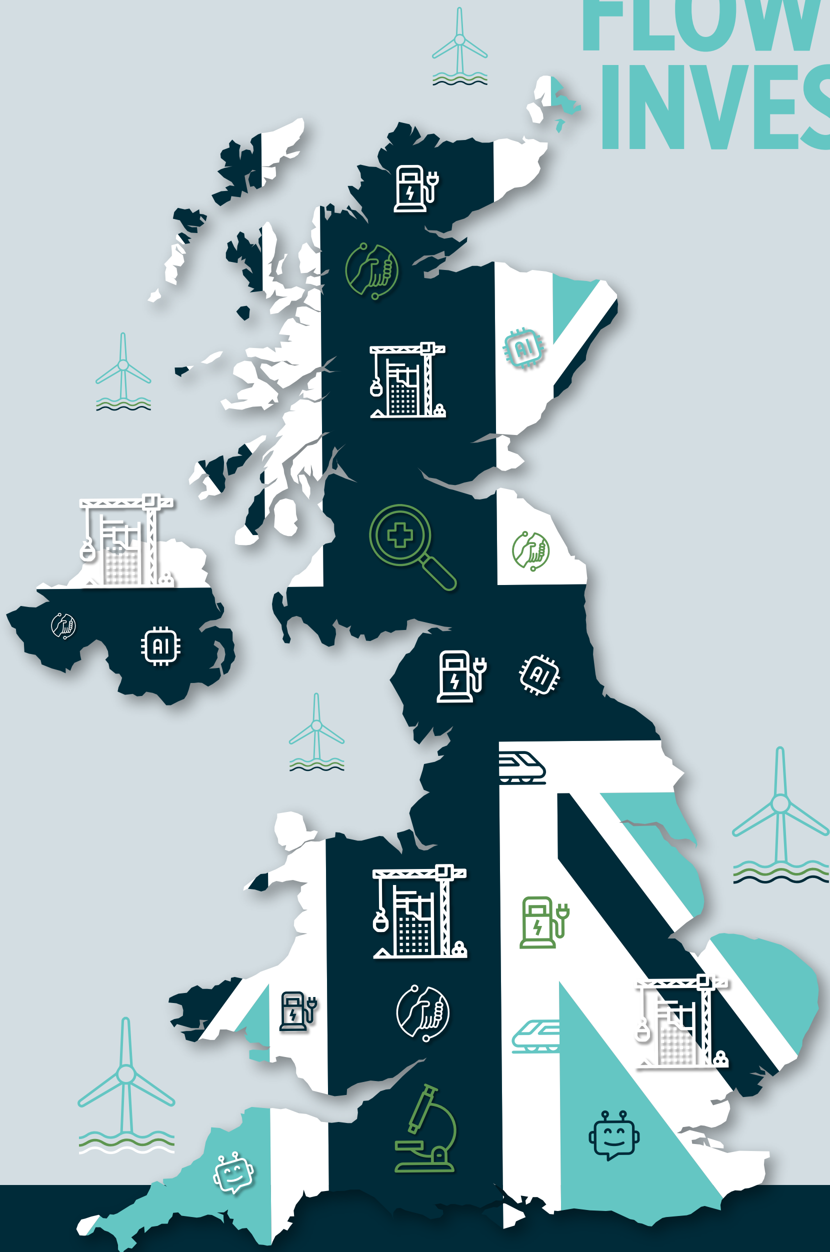
PENSIONS AND LIFETIME SAVINGS ASSOCIATION

PENSIONS & GROWTH: USING INVESTMENT AND FISCAL INCENTIVES TO ENCOURAGE THE FLOW OF PENSION INVESTMENT INTO UK ASSETS



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CONTENTS

ABOUT US	3
EXECUTIVE SUMMARY	4
INTRODUCTION	5
BACKGROUND	6
CATALYSING UK INVESTMENT	8
CONCLUSIONS AND RECOMMENDATIONS	13
ANNEX	14

ABOUT US

We are the Pensions and Lifetime Savings Association, the voice of workplace pensions and savings, and uniquely placed to collaborate with the new Government on its goals for the pensions industry. We are a not-for-profit membership organisation, representing pension schemes that together provide a retirement income to more than 30 million savers in the UK and hold assets of more than £1.3 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs, and others who play an influential role in people's financial futures.

This paper was written in collaboration with Sarah Gordon, Visiting Professor in Practice at the London School of Economics' Grantham Research Institute on Climate Change and the Environment. It draws on both PLSA policy work and research and on LSE research, including *Investing in our future: practical solutions for the UK government to mobilise private investment for economic, environmental and social policy priorities*, published in October 2023[1].

1. Investing in our future: practical solutions for the UK government to mobilise private investment for economic, environmental and social policy priorities, Sarah Gordon, 2023, **https://www.lse.ac.uk/granthaminstitute/publication/investing-in-our-future-practical-solutions-for-the-uk-government-to-mobilise-private-investment-for-economic-environmental-and-social-policy-priorities/**

EXECUTIVE SUMMARY

The Pensions Review, announced on 16 August 2024, includes "encouraging further pension investment into UK assets to boost growth across the country" as a policy area of focus[2].

Workplace pension funds in the UK hold over £3 trillion in assets, the third highest amount in the OECD. Pension fund trustees' fiduciary duty rightly requires they invest in assets which will deliver the best risk-adjusted returns and retirement outcomes for their members.

To catalyse UK investments there are a range of options, of an investment and fiscal nature, which the Government could deploy to encourage greater flows of pension investment into the UK. Below is a summary of these options. These have been grouped by theme and are not a prioritised list:

INVESTMENT INCENTIVES

1. Make greater use of **blended finance**.
2. Expand the already successful **Long-term Investment for Technology and Science (LIFTS) initiative**.
3. **Government commitments on large-scale infrastructure projects** could include guarantees.
4. The capital behind the National Wealth Fund (NWF) and British Business Bank could act as a government-backed **provider of liquidity**. Current plans to establish the NWF should be expanded to create a suitable vehicle to attract pension investment at scale.
5. **Co-investment vehicles with British Patient Capital**.

FISCAL INCENTIVES

6. Reduce the effective tax rate for pensions in holding UK shares by allowing a **tax credit on dividend payments** as has been successfully done in Australia.
7. The issue of **stamp duty** needs addressing. When pension funds buy UK shares, they have to pay stamp duty whereas if they buy shares from other countries they are often not subject to taxation.
8. Pensions could benefit from a discount in their **Pension Levy** if they invest in certain sectors or locations.
9. Investment into the **National Wealth Fund** could be provided with a fiscal incentive, possibly modelled on those used for venture capital trusts (VCTs) and Seed Enterprise Investment Scheme (SEIS).
10. Incentives could be provided for **net zero**, **sector or regionally based** investment.

WIDER PENSIONS POLICY AND REGULATORY REFORMS

11. Implementing **wider reforms to increase investment by UK pension funds**, including changes to the regulatory framework, enabling consolidation of pension funds, and more focus on performance and value for money.

2. See Terms of Reference - https://www.gov.uk/government/publications/pensions-review-terms-of-reference-phase-one/terms-of-reference

INTRODUCTION

This is one of a series of PLSA reports on pensions and growth[3]. Productive investment is central to increasing growth; measures in six areas were identified by the PLSA in its June 2023 *Pensions and Growth* report as increasing the amount of investment in the UK by pension funds:

- **Pipeline of assets:** Ensuring there is a stream of high-quality investment assets suitable for pension fund needs. The PLSA published its latest report on this topic, *Pensions and Growth: Creating a Pipeline of Investable UK Opportunities*, in August 2024[4].
- **Defined benefit regulation:** Introducing greater flexibility into the funding regime for private sector DB schemes, in particular for open DB schemes and those schemes with longer investment time horizons, while protecting the interests of scheme members.
- **Fiscal and investment incentives:** Introducing incentives for pension funds so that investing in UK assets is more attractive than investing in similar assets of other countries.
- **Consolidation:** Prioritising legislation to place DB superfunds (funds which consolidate defined benefit schemes from multiple employers) on a statutory footing and carrying forward, in a pragmatic way, the current programme of measures related to defined contribution (DC) master trusts and the Local Government Pension Scheme (LGPS).
- **Market for DC under automatic enrolment:** Taking a range of actions to encourage more focus on performance and less on cost, for example, the greater use of Value for Money tests and setting the right regulatory regime for employers and their advisers when choosing a suitable pension scheme.
- **Raising pensions contributions:** Increasing the supply of funds for asset purchase, particularly for DC schemes. Over the next decade, automatic enrolment pension contributions should rise gradually from 8% to 12% of salary so that by the mid-2030s employers and employees would each pay 6%.

This report focuses on one of these areas: fiscal and investment incentives for pension funds (and others) to invest in UK assets.

The report covers incentives for investment, fiscal incentives, and investment vehicles. Our recommendations build on the knowledge and expertise of PLSA members, as well as previous PLSA and LSE research into pensions and growth.

3. Pensions and Growth – A paper by the PLSA on supporting pension investment in UK growth, PLSA, 2023, **https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2023/Pensions-and-Growth-Jun-2023.pdf**
4. Pensions and growth: Creating a pipeline of investable UK opportunities, PLSA, 2024, **https://www.plsa.co.uk/Policy-and-Research/Document-library/Pensions-and-Growth-Creating-a-Pipeline-of-Investable-UK-Opportunities**

BACKGROUND

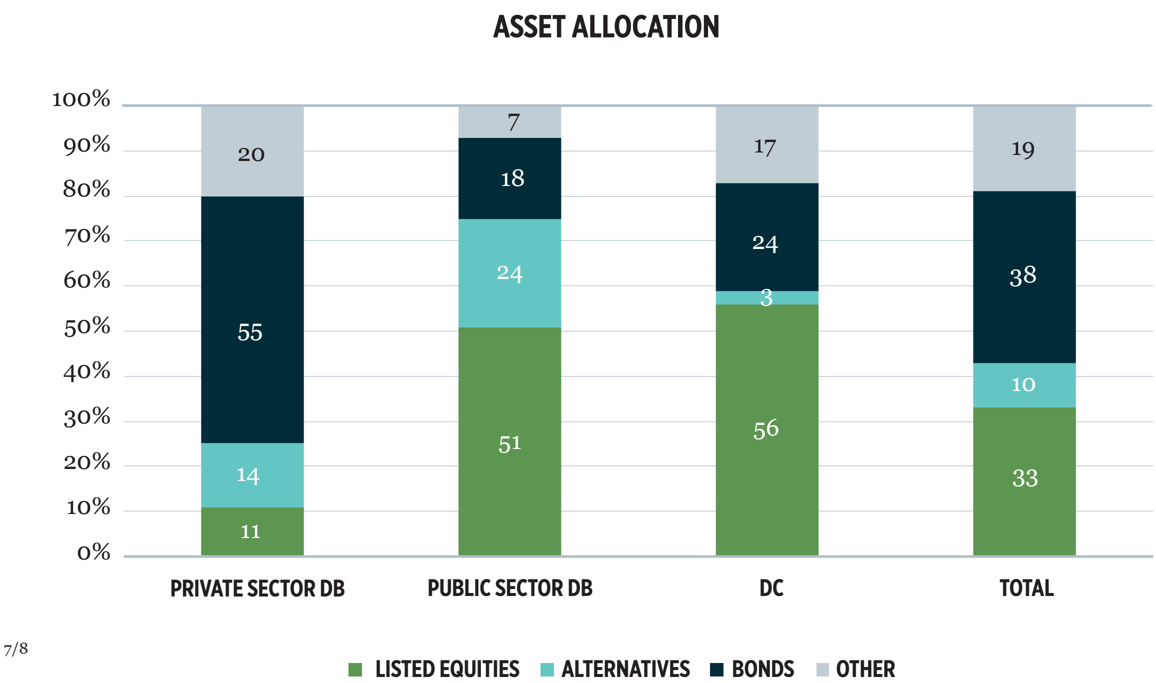
POLICY CONTEXT

The new UK Government has set a goal of encouraging more private investment, including UK pension savings, into economic growth opportunities and the transition to net zero, in particular via the establishment of the National Wealth Fund. It has also committed to a Pension Schemes Bill which proposes consolidation in both the DC and DB pension markets. Further, the new Government launched on 16 August a review of the pensions landscape, the first part of which relates to defined contribution pensions and the Local Government Pension Scheme. One of the objectives of the review is to boost investment[5].

Pension funds have been subject to successive regulatory and accounting changes. Much of this is necessary to protect pension scheme members. In some respects, however, the long-term nature of pension funds, particularly those which remain open, is not sufficiently recognised. Moreover, regulatory changes have encouraged pension schemes to de-risk and consequently pension funds have altered their investment strategies away from riskier investments, including in the UK.

PENSIONS LANDSCAPE

Workplace pension funds in the UK hold over £3 trillion in assets, the third highest amount in the OECD[6]. The type of assets held by funds varies between type of pension scheme, as shown by the graph below.



5. See Terms of Reference - https://www.gov.uk/government/publications/pensions-review-terms-of-reference-phase-one/terms-of-reference
6. Pensions at a glance 2023, OECD, 2023, https://www.oecd.org/en/publications/2023/12/pensions-at-a-glance-2023_4757bf20/full-report/component-51.html#tablegrp-d1e76418-c3a932542
7. Pensions Policy Institute (PPI), 2024, Pension scheme assets – how they are invested and how they change over time, https://www.pensionspolicyinstitute.org.uk/media/coodraok/20240909-ppi-pension-scheme-assets-main-report-final.pdf
8. Alternatives includes private equity, property, Secure Income Alternatives (SIA), infrastructure, private debt and venture capital.

Almost £1 trillion of pension scheme assets are invested in the UK[9]. The extent of UK investment differs by type of scheme. For example, the proportion of investment in UK equities and bonds is 21%, 31% and 40% for open public sector DB, DC, and private sector DB respectively.

Using a definition of UK productive assets that includes listed equities, corporate bonds, private equity and alternatives, the PPI's latest research estimates that 18% of £3 trillion of UK pension AUM is invested in UK productive assets. Using a much narrower definition that extends only to private equity and alternatives, the share drops to 6%[10].

INVESTMENT TRENDS

Over the last 20 years, defined benefit pensions have largely been replaced in the workplace by defined contribution pensions, in particular via automatic enrolment. Defined benefit schemes consequently have a large proportion of deferred and pensioner members who require, or will require, a regular income. Therefore, gilts and corporate bonds, which return a regular yield that meets their regular income needs, are now held in large quantities by these schemes.

Defined contribution schemes, the fastest growing segment of the pensions landscape, currently invest around £106 billion of their AUM in the UK as identified in the PPI's latest research[11]:

- £36 billion is invested in UK corporate bonds
- £51 billion is invested in listed UK equities
- £21 billion is invested in UK property
- £10 billion is invested in UK private equity and alternatives[12].

Whilst DC schemes have committed to investing more in private equity, this transition will take time. Many of the largest DC providers are committed to reaching at least 5% invested in unlisted equity (a market dominated by the UK), by 2030.

Public sector DB schemes' assets under management are increasing, whereas private sector DB schemes' assets are not. They hold a high percentage of growth assets - around 51% in equities with just 18% held in bonds. Almost one quarter of the assets are held in property, private equity and other alternatives. According to the PPI around £150 billion of these investments are in UK assets.

9. Pensions and Growth – A paper by the PLSA on supporting pension investment in UK growth, PLSA, 2023, **https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2023/Pensions-and-Growth-Jun-2023.pdf**
10. Pensions Policy Institute (PPI), 2024, Pension scheme assets – how they are invested and how they change over time, **https://www.pensionspolicyinstitute.org.uk/media/c00dra0k/20240909-ppi-pension-scheme-assets-main-report-final.pdf**
11. Ibid
12. Ibid

CATALYSING UK INVESTMENT

Pension funds exist to provide retirement income for their members. Pension fund trustees' fiduciary duty therefore rightly requires they invest in those assets which will deliver the best risk-adjusted returns for their members. The fiduciary duty underpins the trust by members that their pension fund will be well governed, and their contributions properly invested, sometimes for decades. One of the lessons of the recent success of Canadian pension funds is their strong governance[13].

Current allocations to UK assets reflect their attractiveness, taking into account their relative costs and risk level. In order to kickstart a cycle of investment through which UK investments become more attractive, there are a range of investment and fiscal incentives, which the Government could deploy to encourage greater flows of pension investment into the UK.

INVESTMENT INCENTIVES - BLENDED FINANCE

The new Government's commitment to create a £7.3 billion National Wealth Fund, channelled via the UK Infrastructure Bank (UKIB), could help drive more pension investment into economic growth and the net zero transition. However, as the report of the National Wealth Fund Taskforce makes clear, the NWF will need to be appropriately designed to meet pension funds' risk and return requirements[14].

As currently proposed, the NWF constitutes an injection of £7.3 billion of additional public funds on to the balance sheet of the UK Infrastructure Bank, which will seek to attract pension fund and other institutional investment on a deal-by-deal basis[15].

To maximise the opportunity to attract significant flows of private investment into the NWF, its next iteration should involve the design of a fund structure which would provide appropriate diversification and risk appetite at a fund, rather than deal, level. There are numerous examples in the private sector which could be used as exemplars to inform the design of such a fund, into which trustees would find asset allocation uncontroversial.

The fund could build on research published by the LSE in 2023, which proposes the creation of a diversified, scale fund-of-funds, overseen by UKIB, with individual funds investing in specific sectors like EV battery infrastructure or green hydrogen managed by commercial managers through competitive tender. Designing this, in collaboration with the asset management industry, would not be challenging and has the potential to mobilise tens of billions of investment in a way that is appropriate for taxpayers, savers, asset owners and public investors like the UK government[16].

13. The Evolution of the Canadian Pensions Model, World Bank Group, 2017, https://documents1.worldbank.org/curated/en/780721510639698502/pdf/121375-The-Evolution-of-the-Canadian-Pension-Model-All-Pages-Final-Low-Res-9-10-2018.pdf
14. National Wealth Fund Taskforce report, July 2024 https://www.greenfinanceinstitute.com/programmes/national-wealth-fund-taskforce/
15. More detail on the NWF is expected at the Investment Summit in October 2024
16. Investing in our future: practical solutions for the UK government to mobilise private investment for economic, environmental and social policy priorities, Sarah Gordon, 2023, https://www.lse.ac.uk/granthaminstitute/publication/investing-in-our-future-practical-solutions-for-the-uk-government-to-mobilise-private-investment-for-economic-environmental-and-social-policy-priorities/

The research suggests that making greater use of blended finance approaches, while following best practice guidelines, will be a key determinant of the Government's success in mobilising private investment at sale for its priorities.

Blended finance combines private capital in search of an investment return with other, often more risk-tolerant 'catalytic' capital from public or philanthropic sources. Which structure or instruments to use will depend on a variety of factors, including the potential risks and market failures to be mitigated, what would best incentivise potential investors in any given situation, and the concessions or costs that catalytic investors are willing to accept. A range of blended finance instruments and approaches is set out in the table below.

BLENDED FINANCE INSTRUMENTS AND APPROACHES

CATEGORY	INSTRUMENTS	COMMENTARY
Grants	Repayable and non-repayable grants	Uses include project/fund design and preparation and technical assistance, enabling projects to become commercially attractive, and early-stage R&D where there are positive externalities or risks investors cannot hedge.
Unfunded instruments/ contingent liabilities	Guarantees insurance first-loss facilities	Can be off-balance sheet for provider. Reduce tail risk for projects or portfolios, provide a floor on returns, or protect against a specific risk that the market cannot insure/hedge or misprices.
Co-investment	*Pari passu* equity or debt in sponsored funds and co-investment structures	A sponsor takes first-mover risk to create a portfolio because it has better information on investments and can monitor at lower cost/provide technical assistance. Crowds in investors as scale is created and risks are spread over a portfolio. Funds will often have different tiers for different risk/reward payoffs. Can include first-loss tranche and/or guarantees.
Concessional return funded structures and securities	Subordinated debt / Subordinated equity securitisation	Commonly priced at a concessionary rate. May be combined with a guarantee or first-loss facility to ensure that the overall risk/return profile attracts commercial investors. A junior tranche introduces loss absorption for commercial senior tranches.
Results-based incentives	Outcomes contracts. Outcomes funds. Development impact bonds	Provide incentives to achieve the desired outcomes or results, tying at least a portion of payments to achievement. The payments can go to both investors and service providers (and reduce the upfront capital required) assuming targets are met.
Broader enabling policy instruments	Tax credits. Subsidies. Risk reduction mechanisms e.g., price floors	Whilst not blended finance instruments per se, these policy instruments can help to crowd in commercial investors by changing the risk/return profile, and/or incentivising investment in areas where there are externalities/spillovers. Can provide markets for hedging risks where they do not currently exist.

INVESTMENT INCENTIVES - LIFTS

There are already examples of blended finance under consideration in the UK, as part of the **Long-term Investment for Technology and Science** (LIFTS) initiative, which through 2023 allowed DC pension schemes and their managers to apply for support from the British Business Bank (BBB) for investments into UK science and technology. Through the consultation stage there was support for all four of the proposed incentives which included:

- Collaboration on investment from British Patient Capital (BPC) enabling schemes to invest alongside and leverage expertise. This would allow DC investors to access private markets at a lower cost.
- *Pari passu* co-investment where BPC would co-invest in new structures set up by industry, committing funding at scale to new vehicles.
- BBB would co-invest in new industry funds and structures, but with capped returns, enabling a greater upside to private investors in the fund.
- Fee offset mechanisms would see government cover some of the higher annual management charges associated with these assets, which would enable more of the cost-constrained DC industry to access them. Fees would need to be reimbursed once a pre-defined hurdle has been reached.

There has been positive uptake of this initiative: Schroders' specialist private markets investment division has been awarded £150m by the British Business Bank to invest into UK science and tech companies, while ICG was awarded £100m to invest into the UK's most innovative life sciences companies. This will be supported by pensions capital from Phoenix Group, together with £250m from the Government. However, given the scale of the investment and growth challenge, we would encourage Government to go beyond the £250m already committed to this initiative.

The LIFTS initiative is the best existing example of government-backed investment incentives, but there are other, similar measures which would positively alter the risk/return calculation for pension funds which we would urge the Government to consider. These include **first-loss structures**, typically used in the hedge fund industry, that enable co-investment between government and private investors, in this instance DC schemes, with the initial downside risk absorbed by government. This means that for DC schemes –including savers in the default fund – the risk of loss can be contained, while still being exposed to any outperformance.

LSE research demonstrates that, deployed well, blended finance can enable government to crowd in multiples of private investment to address pressing economic, environmental and social challenges. From its research across a range of UK and overseas case studies, it is clear that for such initiatives to succeed there needs to be trust, accountability and clarity of investment objectives between all parties, and that careful governance is needed to maintain the balance between financial return and policy objectives. LSE concludes that if this best practice is followed, and that lessons are learned from previous public-private partnerships, investment can be catalysed in growth sectors of the UK economy, while providing stronger returns for pension savers.

INVESTMENT INCENTIVES – GOVERNMENT COMMITMENTS ON LARGE-SCALE INFRASTRUCTURE

One of the largest risks investors in long-term infrastructure projects take is that projects are cancelled or materially changed years down the line as a result of changes in government strategy or funding. Such risks are outside the control of private investors, but if **government provided long-term commitments at the outset**, such as guarantees that investors will get their money back in the case that plans changed, the confidence created would catalyse more investment in domestic infrastructure.

Another risk schemes take with private market and infrastructure assets is liquidity, and the concern that they may not be able to sell if they need to. A solution to this would be the BBB (or another institution) acting as a **government-backed provider of liquidity**, meaning schemes could always sell assets if they needed to raise cash.

NB We provide some additional examples of blended finance, drawn from the USA and the EU in the annex.

FISCAL INCENTIVES

As well as blended finance measures, there are various tools for government to incentivise investment into specific sectors through fiscal means.

- **Dividend tax credit:** The high allocation of domestic equities in Australia is at least in part a result of tax credits to Australian investors on dividends paid by Australian companies. This reduces the effective tax rate on domestic equities to zero. In the UK, dividend tax credits on advance corporation tax were abolished for pensions in 1997. This was designed to encourage companies to reinvest profits rather than pay them out in dividends. Reinstating the dividend tax credit, or a version of this, would drive a substantial change in investment behaviour more quickly than many other measures[17] .
- **Stamp duty exemption for UK shares:** When investors buy UK shares, they currently pay stamp duty. This is the case in many jurisdictions – but not all – and this can therefore make UK shares more expensive than overseas equities. Government could exempt pension funds from paying stamp duty for UK shares, thus making them more attractive, or, to reduce the cost to government, it could target exemptions on only UK shares in certain priority sectors.
- **Levy discounts:** All pension schemes pay levies, including the General Levy, Fraud Compensation Fund (FCF) levy and Pension Protection Fund (PPF) levy. These levies could be used as part of an incentive system which offered levy discounts for schemes investing above a certain proportion of assets in a particular way, e.g. in UK infrastructure. Altering the cost-benefit ratio of certain assets in this way could make them better investments in relation to the fiduciary duty.
- **Tax credits for investment vehicles:** Pension, venture capital and other private equity investors into the new National Wealth Fund, and other potential vehicles designed for the same purpose, could be offered an incentive modelled on the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS).
- **Net zero, sector and regionally based incentives:** There is considerable scope for enhancing tax incentives for net zero investments, particularly in fixed capital or innovation. There are examples in the UK already, for example, electric vehicles and charging points are eligible for full expensing in the year of purchase. Incentives for investment in specific technologies in specific places – as envisaged in the US Inflation Reduction Act – would encourage investors with a place-based focus, such as Local Government Pension Scheme funds, and enable government or local authorities to target investment into areas of specific economic need[18].

17. New Financial, 2024, Comparing the Asset Allocation of Global Pension Systems, **https://9075c432-8d38-4fcf-8025-d4433c9ea618.usrfiles.com/ugd/9075c4_e0e4863c058642b88aa61ce56bad5f79.pdf**
18. Sarah Gordon and Anna Valero, **Finance for the Future**, Resolution Foundation, 26 October 2023 https://economy2030.resolutionfoundation.org/reports/finance-for-the-future/

CONCLUSION AND RECOMMENDATIONS

UK workplace pension funds hold over £3 trillion in assets, the third highest amount in the OECD. There is certainly scope to incentivise more of those assets to be invested in the UK in the best interests of pension scheme members.

There are a range of options, of an investment and fiscal nature, which the Government could deploy. The options outlined in this report are summarised below:

INVESTMENT INCENTIVES

1. Make greater use of **blended finance**.
2. Expand the already successful **LIFTS initiative**.
3. **Government commitments on large-scale infrastructure projects** could include guarantees.
4. The capital behind the National Wealth Fund and British Business Bank could act as a government-backed **provider of liquidity.** Current plans to establish the NWF should be expanded to create a suitable vehicle to attract pension investment at scale.
5. **Co-investment vehicles with British Patient Capital.**

FISCAL INCENTIVES

6. Reduce the effective tax rate for pensions in holding UK shares by allowing a **tax credit on dividend payments** as has been successfully done in Australia.
7. When pension funds buy UK shares they have to pay **stamp duty** whereas if they buy shares from other countries they are often not subject to taxation.
8. Pensions could benefit from a discount in their **Pension Levy** if they invest in certain sectors or locations.
9. Investment into the **National Wealth Fund** could be provided with a fiscal incentive, possibly modelled on those used for VCTs and SEISs.
10. Incentives could be provided for **net zero**, **sector or regionally based** investment.

WIDER PENSIONS POLICY AND REGULATORY REFORMS

11. Implementing **wider reforms to increase investment by UK pension funds**, as set out in earlier PLSA reports, including changes to the regulatory framework, enabling consolidation of pension funds, and more focus on performance and value for money.

ANNEX - INTERNATIONAL EXAMPLES OF BLENDED FINANCE: USA AND THE EU

Other governments are pursuing large-scale blended finance initiatives, which are successfully attracting investment both nationally and internationally. These include the US Inflation Reduction Act (IRA), which directs nearly $400 billion in federal funding to clean energy, with the goal of substantially lowering the nation's carbon emissions by 2030[19]. The funds are delivered through a mix of tax incentives, grants and loan guarantees, and analysts estimate that the IRA will unlock $3 trillion in private sector investment over the next decade[20].

In the EU, the Green Deal commits over €1 trillion to transition member countries to a sustainable economic model[21]. A key element of the Green Deal is the InvestEU programme, which aims to use guarantees from the EU budget to crowd in €372 billion public and private investment[22].

19. Jenkins J, Mayfield E, Farbes J, et al. (2022) Preliminary report: The climate and energy impacts of the Inflation Reduction Act of 2022. Princeton, New Jersey: REPEAT Project, Princeton University. **https://repeatproject.org/ docs/REPEAT_IRA_Prelminary_Report_2022-08-04.pdf**
20. Boushey H (2023) The Economics of Public Investment Crowding in Private Investment. Blog post, 16 August. The White House. **https://www.whitehouse.gov/briefingroom/blog/2023/08/16/the-economics-of-publicinvestment-crowding-in-private-investment/**
21. European Commission (2019) A European Green Deal. Web Page. **https://commission.europa.eu/strategy-andpolicy/priorities-2019-2024/europe-an-green-deal_en**
22. European Commission (n.d) InvestEU programme. Web Page. **https://investeu.europa.eu/index_en**

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