Take the long road?

Pension fund investments and economic stagnation

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Executive summary

Improving the long term investment rate of the UK economy is vital to supporting infrastructure renewal and technological development, which sustain economic growth in capitalist economies through increasing productive capacity. Improving UK productivity is also **essential to ensuring that the UK can bear a higher old age dependency ratio** as the population ages. Given their vast capital holdings, pension funds were identified by the coalition government as central to efforts to increase long term investment (and of course the pensions system is directly affected by the implications of population ageing, insofar as it is reflected in scheme membership demographics).

However, **we do not know a great deal about how pension funds invest**. Several high-level trends are identifiable from the available evidence, such as large scale de-equitisation in favour of fixed income assets, and overall these trends suggest a growing tendency towards short-termism. But detailed data is limited, especially given the move towards insurer-run defined contribution schemes. Furthermore, it is **difficult to jump from evidence of short-termist investment *practice* to the conclusion that pension funds are employing short-termist investment *strategies***. There are a large number of issues which cloud any assessment of short- and long-termism, such as the relative lack of control of trustees over specific investment decisions in trust-based schemes, limitations and inconsistencies in how certain asset classes are reported and categorised, and the sometimes paradoxical role of ostensibly short term investments in supporting long term investment, by pension funds or in the economy more generally (and vice versa).

This paper defines long-termism broadly in terms of investors accepting a degree of *uncertainty* in investment decisions, rather than simply *risk*. The possibility of significant returns depends on the investment itself, or the investor, having a transformative impact on the recipients of the investment, or the environment within which they operate. Long term investments are dynamic.

On these terms, it is clear that **the UK pensions system is not sufficiently geared towards facilitating long term investment by pensions funds**, and that the coalition government's policy agenda in this regard – largely taken forward by the Conservative majority government – was not focused on addressing the key barriers. **A 'nudge' agenda, typified by the establishment of the Pensions Infrastructure Platform, has failed to encourage greater pension fund investment in infrastructure**, and indeed symbolises the coalition's excessive (and quite moralistic) focus on public sector pension schemes. Insofar as pension funds are investing in infrastructure, they are using securitised debt instruments to *replace* rather than *augment* public investment.

The dismantling of risk-sharing mechanisms within the UK pensions systems is one of the main reasons that pension funds have been unable to embrace the uncertainty of genuinely long term investments. This process has intensified since 2010. We also have to recognise the strengthening of the regulatory environment around pensions saving. Although designed to protect members' savings, **too often regulation has had the impact of disabling the potential for long term investment**, not least due to its interaction with population ageing. The fixation of regulators on scheme funding has distracted us from the most important way of protecting members, that is, scheme governance arrangements.

Some stakeholders – and indeed policy-making elites – have sought to equate long-termism with the agenda around responsible investment. **A stronger focus by pension funds on issues around corporate stewardship would probably be beneficial to the prospect of increasing long term investment (although the evidence is mixed) – yet this is the most under-developed aspect of the responsible investment agenda**. John Kay's review of long term decision-making in UK equity markets strongly endorsed stewardship, yet failed to consider why specific group of investors, such as pension funds, have thus far resisted greater responsibility for corporate stewardship.

The most important policy priority in terms of enabling long term investment by pension funds is to **defend defined benefit provision**. There are various ways in which this could be done, but the paper advocates, in particular, mechanisms for **adjusting pension entitlements as pension scheme demographics change**. This will allow defined benefit schemes to respond to population ageing in a way that is less disruptive to investment strategies. It is also possible to make defined contribution provision operate more like defined benefit provision, through the **introduction of collective defined contribution** (CDC) schemes. The government should explore how to transform NEST into a CDC scheme, but must also reverse recent pensions 'liberation' reforms to enable large employers to adopt CDC in place of individualised defined contribution.

The government should also establish **national and local economic renewal funds**. These would be funded by near-compulsory allocations by all workplace pension schemes. Any individual or firm would be able to bid to the fund for investment, into projects consistent with improving the productive capacity of the UK economy. A more moderate version of this proposal would see existing pension schemes compelled to develop **investment strategies more commensurate with the geographical location of their UK workforce**.

The paper also advocates an enhanced role for the state in supporting pension funds to facilitate long term investment through its unrivalled capacity to hedge risks, including **offering hypothecated investment bonds to institutional investors** and **providing annuities to defined contribution savers**.

Introduction

The 2008 financial crisis and subsequent stagnation in the UK economy gave renewed prominence to one of its longstanding handicaps. The relative lack of long term investment within the UK economy can be associated with both the housing market and asset price booms which created significant volatility in the pre-crisis period, and with the sluggishness of the post-recession recovery which has ostensibly been underway since late 2009.

Improving the long term investment rate of the UK economy is vital to supporting infrastructure renewal and technological development, which sustain economic growth in capitalist economies through increasing productive capacity. Productivity is one of the key weaknesses of the UK economy, relative to most similar economies; overcoming this will be essential to ensure that the UK can bear a higher old age dependency ratio as the population ages.

Pension funds lie at the centre of this undesirable status quo. They are, to some extent, the victims of the UK's economic short-termism. The economy is not creating sufficient opportunities for long term investment to which pension funds can allocate significant amounts of capital. The withdrawal of public investment since the recession by the coalition government, and now Conservative majority government, since 2010 has, somewhat perversely, exacerbated this trend.

Furthermore, the increasing unwillingness of employers to support traditional 'defined benefit' (DB) pension schemes means that the associated funds have less capital to invest. This trend is evident in the closure of existing schemes to new members or future accruals, or a downgrading of entitlements associated with scheme membership, both of which generally reduce contributions into schemes. It is of course most evident, however, in the replacement of DB provision with 'defined contribution' (DC) schemes, which are generally less able to pursue long term investment strategies.

On the other hand, pension funds can be said to be perpetrators of the UK's chronic economic short-termism (although certainly not the main perpetrators). UK pension funds are hugely significant capital market participants. Their embrace of securitisation in the 1990s had a transformative impact on investment practice in the City of London. More generally, pension funds also highly value liquidity in investment – that is, assets that can be traded quickly – and tend to trade some assets at a relatively high frequency in order to track investment benchmarks.

These changes, however, are strongly associated with pension funds' efforts to reorient their investment practice in light of the maturity of their membership demographic. Scheme memberships of most DB funds reflect both the ageing of the UK population in general, and the consequences of closing schemes to new, younger members. As such, while demographic change with pension scheme membership profiles means that the higher yields generally associated with long term investment are more important than ever to ensuring scheme sustainability, it is the cash demands related to a higher proportion of pensions-in-payment, relative to accumulating funds, that means the greater liquidity of short term investments is prized by the pensions system.

Given the vast size of UK pension funds, it is not surprising that policy-makers have looked to them in the post-crisis environment to reorient their investment practice towards the long term. Such a move would ostensibly facilitate the kind of 'real economy' investments that would strengthen the economic recovery. But many questions about this agenda remain unanswered. Is reorientation in pension fund investment practice a realistic prospect? Is it fair on pension funds –

and scheme members – to expect them to shoulder this burden? Has policy been sufficiently focused on addressing the causes of short-termism in pension fund investments, and the barriers to a more long-termist approach? This paper seeks to address these issues, in order to outline a series of policy options for enabling long-termism in pension fund investments.

Part of the problem, however, is that what long term investment actually looks like is not always clear. There is also an acute shortage of detailed data on how pension funds invest, especially in terms of the balance between short and long term investments. The first section briefly outlines what we know about pension funds' existing capital allocations, and explores the difficulty of establishing what qualifies as a long term investment. The next four sections look at different aspects of this policy area, including the agenda around increasing infrastructure investment, the prospect of new forms of risk-sharing (and how the increasing need for liquidity impacts upon this prospect), the role of regulation in shaping pension fund investments, and the controversial issues of responsible investment and corporate stewardship. The final main section considers what role the state could play in enhancing long term investment by pension funds, before the conclusion summarises the paper's arguments and offers a series of recommendations.

What do we know about pension fund investment allocations?

This section summarises the available evidence on pension fund investments, before considering what, if anything, can be inferred about the time horizons of these investments. As noted in the Introduction, however, the evidence on pension fund investments is frustratingly limited. The Pension Protection Fund's (2014) Purple Book is perhaps the most comprehensive source. It contains information on private sector defined benefit schemes, where the majority of pension assets remain. Key findings from the latest edition are:

- Equity investment has fallen sharply to around a third of total asset allocation, from around two-thirds before the financial crisis.
- Within equity investment, overseas equities now strongly outweigh UK equities – the two were roughly equal at the time of the financial crisis.
- Over the same period, allocations to gilts and fixed interest securities has risen from under 30 per cent to around 45 per cent.
- This has been a marked increase in holdings of cash deposits, doubling to 6 per cent of total asset allocations since 2008.
- There has been a steeper increased in allocations to hedge funds, from a negligible amount at the time of the financial crisis, to almost 6 per cent.

The over-riding trend is one of de-equitisation, a process which was evident many years before the financial crisis. A study on procyclicality in UK institutional investment following the financial crisis by the Bank of England and the Procyclicality Working Group (2014) found that decisions over equity allocations were largely 'acyclical'. While there was some evidence of counter-cyclicality (buying more equities as prices fell), which we might translate as a long-termist approach to investment, this was largely due to a mechanical adjustment to falling prices, as a given asset allocation balance was maintained. In general, the longstanding move towards de-equitisation, essentially a form of de-risking, was maintained irrespective of the crisis, and actually had procyclical affects insofar as it contributed to falling equity prices.

Moving away from equities investment, and towards gilts and similar assets, reflects scheme maturity, as equities are usually more volatile than gilts. We can see a similar dynamic in the moves towards cash deposits and hedge funds – although the latter is a volatile investment, it offers significant liquidity. This is important in schemes were an increasing number of members are in retirement.

The Office for National Statistics (ONS, 2014) publishes data on investment by both insurance companies and pension funds, therefore encompassing virtually the entirety of pensions saving vehicles in the UK. However, the data is limited in several regards:

- Although the ONS distinguishes ‘general’ insurance providers from ‘long term’ insurance providers, it does not distinguish pension-related investment within the long term category (and therefore, nor does it distinguish pension-related insurance investments associated with the accumulation and decumulation phases).
- Within data on pension funds, there is no distinction between defined benefit and defined contribution schemes. Relatedly, this also means to offer any meaningful information on defined contribution pension investments – contract-based schemes are subsumed into the long term insurance category, and trust-based schemes are subsumed into the pension funds category.
- The distinction that the ONS makes between short term and long term assets is quite peculiar. It treats as long term any asset that could be held for a long period, or indefinitely, even if in practice they are not.

Nevertheless, it is possible to say that, in general, the broader ONS data conforms to the main trends evident in the PPF data on private sector defined benefit pension funds. Viewed together, we can conclude that pension funds are moving away from equities, but continuing to favour overseas rather than UK equities. They have moved strongly into gilts since the financial crisis, and significantly increased their allocations to highly liquid cash deposits. Most of the same trends are evident among investment by long term insurers, although the move to gilts and related products has been much less stark.

The available evidence suggests therefore that pension funds are increasingly interested in risk management, cashflow and liquidity – bywords for short-termist investment, even if in each case the motives are understandable. However, it is difficult to jump from evidence of short-termist investment *practice* to the conclusion that pension funds are employing short-termist investment *strategies*. There are a large number of issues which cloud any assessment of short- and long-termism:

- Those responsible for pension schemes do not necessarily know exactly how their capital is being invested. This is clearly the case in contract-based DC schemes, run by insurance companies, but also most trust-based DB and DC schemes, within which investment is out-sourced to asset management firms.
- As noted above in relation to the ONS data, many assets could be held for a long period of time, but are invariably traded. Pension fund holdings of listed equities are an example of this.

- On the other hand, even where it appears that equities are being traded at high frequency, this does not mean that firms are entirely abandoning investee firms in a single transaction – typically they will simply be adjusting their holdings in a particular firm.
- Some of the most controversial practices, such as derivatives investment, may appear to fuel short-termism in capital markets, but are also used as a form of insurance by pension funds which hold related 'real' assets.
- Assets such as gilts can be explicitly short term in nature, or purposefully held for a short period of time, but in enabling public borrowing may support long term investment by the state.
- Investment in property is often seen as an alternative to short-termist investment, and clearly is less liquid than gilts or listed equities, but may be fuelling short-termism in the economy more generally as property drains capital from productive activity.
- Other illiquid investments, such as private equity, may ostensibly appear to be longer term investments, but can be fairly opaque, and therefore difficult to evaluate.
- Infrastructure is the archetypal illiquid, long term investment. But the form of infrastructure investment often taken by pension funds (as discussed in the second section) means it may simply be replacing public investment – contributing to short-termism in the management of the public finances.

Clearly, the essence of long-termism cannot be found in any particular type of asset class or investment practice. Crudely, genuinely long term investment encompasses accepting a degree of *uncertainty* in investment decisions, rather than simply *risk* (Keynes, 1937). Returns, and potential losses, from investment therefore cannot be accurately predicted, or hedged. The possibility of significant returns depends on the investment itself, or the investor, having a transformative impact on the recipients of the investment, or the environment within which they operate.

The potential results of this dynamic interaction are unknowable. The problem for pension funds, therefore, is that their long term liabilities are very much known – meaning they tend towards investments which offer predictable returns. This is one of the crippling paradoxes of 'pension fund capitalism', a concept developed by Gordon Clark (2000) in recognition of the potential, collective economic clout of increasingly large pension funds in the UK and United States at the turn of the century. They have the *resources* to engender transformation within patterns of capital allocation, but an *obligation* not to.

The coalition government's infrastructure agenda

The coalition government's agenda around lengthening pension fund investment horizons focused principally on increasing infrastructure investment. Yet as conventionally understood, infrastructure investments do not necessarily fit well with funds' growing interests in risk-management, cash-flow and liquidity. It often involves investments in large-scale physical assets with limited liquidity and uncertain returns.

However, the coalition government focused on encouraging or 'nudging' funds to invest in infrastructure, rather than offering substantive support to overcome this key barrier. This approach seems likely to continue. The government's National Infrastructure Plan signalled pension funds as a key future source of infrastructure investment in the UK, yet the actual policy agenda in this regard amounted to little more than signing memoranda of understanding with various local authority funds regarding their plans to invest in some of the Treasury's earmarked priorities (HM Treasury & Infrastructure UK, 2011).

Perhaps the most high-profile activity in this area was the creation of the Pensions Infrastructure Platform (PIP). The PIP is an initiative led by the National Association of Pension Funds (NAPF) at the behest of the government, with the support of the Pension Protection Fund, and employing infrastructure specialists Dalmore as investment manager. The scheme allows pension funds to pool the risks associated with investing in infrastructure. Although no explicit financial target was announced, that only around £1 billion (a negligible proportion of total funds) has been committed by pension funds to date is undoubtedly a disappointing outcome.

The PIP and similar endeavours indicated the coalition's view that scale is the main barrier to pension fund infrastructure investment. Larger funds have, in theory, more capacity to diversify and shoulder illiquidity risks, and to retain in-house expertise on unconventional investments such as infrastructure. The hope was that smaller funds can replicate scale through forming investment consortia. Some left-leaning organisations have developed similar initiatives, such as the Investing 4 Growth consortium (a partnership between a handful of local authority pension funds), based on research by the Smith Institute, the Centre for Local Economic Strategies, and Pensions and Investment Research Consultants (2012).

In practice, the coalition government's infrastructure agenda, in relation to pension funds, was targeted almost exclusively on reorienting the behaviour of unfunded public sector schemes. This bias was strongly evident in the initial membership of the PIP. Furthermore, one of the few substantive regulatory reforms implemented by the coalition government to enable infrastructure investment was the change implemented to the restrictions on local authority funds' investment in partnerships (which are a common method of infrastructure investment) despite significant concerns about local authority pension fund governance, and the opacity of many private equity-based investment partnerships (Berry, 2013).

The flipside of this approach is that the possibility of private sector schemes participating in the coalition's infrastructure agenda was largely discounted – not least because of the implications of coalition policy. The ending of 'contracting out' as a result of the single-tier state pension, and the nature of automatic enrolment regulations, signalled the coalition's support for the decimation of defined benefit in favour of defined contribution provision. Because defined contribution pensions involve individual rather than collective investment, illiquid assets with uncertain, long term returns are generally highly unattractive.

However, as the local authority change suggests, it is worth noting that infrastructure is generally not treated as an asset class. There are many ways to invest in infrastructure, including very conventional listed equity investments in infrastructure companies, and schemes rarely distinguish such investments when reporting asset class allocations. Moreover, while the coalition government's vision is of pension funds investing in UK infrastructure, helping to rebalance the economy in the process, they appear more likely to invest in overseas infrastructure projects (MacPhee, 2014).

Increasingly, however, investment in UK infrastructure is taking the form of securitised debt instruments – following the example of Australia (Inderst & Croce, 2013). It appears to be largely constituted by investment in *social* infrastructure (typically, schools and hospitals), facilitated by the Private Finance Initiative (PFI). Australia has been more successful than the UK in persuading its pension funds to participate in the privatisation of social infrastructure construction and maintenance – which explains the coalition government's reinvention of PFI as 'PF2'. Through PF2, the state will take greater responsibility for construction risks (HM Treasury, 2012), in part to assuage the most common fear evident among institutional investors.

This development might ostensibly increase pension funds' infrastructure investment, albeit with several caveats. Increased investment within social infrastructure does not necessarily equate to greater long-termism within the economy, and the debt-based products which facilitate this investment are explicitly designed to offer more liquid investments with stable returns – undermining their transformative potential. Furthermore, we can dispute the notion that this represents *new* investment in infrastructure of any type; rather, it is replacing the state's traditional role in funding infrastructure investment, and the more recent role of the banking sector in PFI projects.

Risk-sharing: gone and soon forgotten

The basic premise of sharing the risks in an investment is not difficult to understand. Let's say that I have £100,000 worth of pensions saving, and the opportunity to invest £100,000 in a project which, if successful, will double my money. But what if it isn't successful? There might only be a one-in-ten likelihood, for instance, that I will lose all of money – but this is actually an enormous risk when the outcome would be that I would have nothing left to live on in retirement.

So, I share the investment with ten other people. Of course, this means I'm only investing £10,000 and can only expect to get, at best, £20,000 back. But because we now have a collective pot of £1 million, we are able to invest in ten such projects. Assuming each project has a one-in-ten risk of total failure, we can expect one of the projects to produce nothing. But if the other nine deliver as promised, the group will have made £900,000 – not quite doubling our money, but not far off.

Moreover, if we were investing as individuals, not only would we have to forgo some lucrative investment opportunities, it also means that the economy loses this capital, or more precisely, the kind of high-risk projects that, if successful, deliver the largest economic benefit, will not attract sufficient investment. This is of course a highly stylised example, but it helps to shows precisely why risk-sharing is so important to unlocking the potential for long term investment by pension funds. In practice, risks have been shared by thousands of people, with decisions made on their behalf by trustees, with a legal duty to act on members' behalf alone. And increasingly, regulation has thickened to ensure that trustees do their job correctly (discussed further in the next section).

The problem, however, is that the UK pensions system is heading in the opposite direction, as it transitions rapidly from collectivised defined benefit pensions to individualised defined contribution pensions. Automatic enrolment mandates employers to establish a workplace pensions scheme, which is a very god thing, but the vast majority of employees will end up in defined contribution schemes. There are of course elements of both forms of provision that cloud this slightly simplistic picture: in defined benefit, it is actually sponsoring employers rather than scheme members that shoulder investment risks. In defined contribution, including (or especially) where investments are managed directly by insurance companies, although risks are technically not *shared*, they are usually *spread* by investing, by default, in pooled funds.

However, there is no doubt that long term, uncertain investments are more difficult in defined contribution schemes, principally due to the need for disinvestment by members at the point of retirement, so that they can turn their savings into a retirement income. There is no such disinvestment in defined benefit; in collective schemes, pensions are paid out of contributions coming in from working-age members. The closure of the vast majority of defined benefit schemes to new members, and even future accruals – meaning contributions end or decrease significantly – makes the benefits of risk-sharing impossible to realise in full.

Due to automatic enrolment, defined contribution schemes will be able to rely on a steady stream of contributions from younger members for several decades. Yet they are unable to maximise the benefits of this – and the coalition government's changes to the annuitisation process, implemented in April 2015, will significantly worsen this situation. The most devastating changes will probably be to the annuities market, as an end to compulsory annuitisation means annuities will become more expensive for ordinary savers (who will still need to buy an annuity to fund their retirement, even if they are not compelled to do so) Yet in also allowing anybody aged 55 or over to access their pensions saving in full, with limited tax restrictions, by intensifying the need for liquidity in defined contribution investments (Berry, 2014a).

Perversely, these changes – orchestrated by the Treasury – were announced at the same time that the Department for Work and Pensions announced new legislation to enable 'collective defined contribution' (CDC) provision. These schemes mimic traditional defined benefit schemes by operating a single investment fund for all members of the schemes, that is, risk-sharing arrangements. There are some who believe that this move towards greater individualisation inherent in the coalition government's liberation agenda will actually herald a rebirth of collective provision, because one of the barriers to the development of these schemes in the UK has been that the requirement to annuitise prohibits the possibility of purchasing a *nominal* annuity from within your own scheme's fund – without this 'self-annuitisation', CDC had little value. This may now change – and defined contribution will move even further back towards the defined benefit model.

However, this account is far too optimistic. Although it is possible the reforms will enable some savers (probably higher earners) to establish or join bespoke investment vehicles offering a form of self-annuitisation, for the mass market, the need for schemes to mitigate the risks inherent in early withdrawal will prohibit long term, illiquid investment, even if self-annuitisation is theoretically possible. The prospect of CDC becoming a mass market pension product depends on greater compulsion, not greater freedoms. I have little incentive in sharing risks with members that may jump ship at any moment – and the risk that they may will have a detrimental impact on the investment strategy, harming both individual outcomes and the wider economy. In a CDC scheme, cashflow is crucial, and members must be denied the opportunity to remove a huge chunk of cash from the scheme any time they choose, for the sake of the fund's investment strategy. In return for this constraint, individuals would receive much higher investment returns, and benefit from stronger scheme governance (Berry & Stanley, 2013; Pitt-Watson & Mann, 2012). The coalition's liberation agenda therefore dismantles the economic basis of CDC, and with it, perhaps, the last hope for collective pensions provision in the UK.

Regulation, ageing and economic change

The prospects for greater long term investment by UK pension funds have to be considered in light of the regulation of defined benefit pension fund management – and the economic and demographic rationale that often lies behind regulation. Various strands of regulation which are worth considering here:

- The Financial Reporting Standard 17 (in force from 2000) and International Accounting Standard 19 (applied in the UK from 2005) regulations mean that sponsoring employers must recognise pension fund deficits in their reports. This makes minimising scheme deficits a priority for firms anxious about their own ability to raise funds on capital markets – and therefore investment strategies are based on minimising losses rather than maximising returns, and uncertainty is anathema.
- The three-year valuation cycle for funds legislated for in the Pensions Act 2004 serves to reinforce short term investment horizons. Schemes are looking to minimise losses within the cycle – therefore problematising longer term investments – to avoid the need for deficit recovery action.
- The creation of the PPF has further problematised riskier investments, as the levies schemes pay to fund the PPF (a form of insurance for scheme members) is calculated based on the risk of scheme insolvency, which is obviously higher with more uncertain investments.

Ostensibly, the tightening of regulation has taken place in order to protect pension scheme members, with greater transparency and separation between funds and sponsoring employers. But it has also, undoubtedly, occurred to protect employers from the perceived risk of rising costs, in the wider context of the financialisation of corporate governance, in which short term profits and share value have become the principal concerns of business. One of the main (and arguably inadvertent) impacts of tighter regulation has been a concentration on conventional asset classes.

It is often argued that the problem for defined benefit provision is not regulation, but rather the way that regulation interacts with demographic changes such as population ageing. With the maturing of scheme memberships, so the argument goes, full funding becomes increasingly aspirational, and requires a burdensome level of sponsoring employer commitment. The argument is profoundly flawed. Increasing life expectancy is something to be celebrated; I hear people say this a lot but, far too often, it is said insincerely. Although I would not dispute that ageing problematises certain forms of economic practice, the implication that population ageing society is problematic for our economy overlooks the fact that living standards have been on a steep upwards trajectory for several centuries – funded by the proceeds of higher productivity and economic growth. As a society, we can afford to live longer, and spend a lower proportion of our lives at work.

Moreover, although significantly extended working lives are impossible for most people at the moment, technological change and medical advances may genuinely transform the relationship between age and work in the foreseeable future. At the same time, it is not inconceivable that problems associated with inequality, urbanisation and climate change may mean that recent advances in longevity actually go into reverse, or at least stagnate.

Even if we have reached a critical moment of development whereby adjustments to some practices are necessary to restore the normal trajectory of growth, such adjustments seem quite straightforwardly achievable. Firstly, we could move towards multi-employer and industry-wide defined benefit schemes, to reduce the burdens on individual employers. Secondly, part of the reason for the perception that ageing makes defined benefit provision too expensive is that employers are not operating in a level playing field. The solution is simple: make defined benefit provision mandatory (as defined contribution now is). It would again become part of the normal cost of doing business. Arguably, compulsion would be introduced most effectively at the European level.

Thirdly, it seems entirely reasonable that pension entitlements could be altered in light of significant changes to the life expectancy of different cohorts within scheme memberships. This would of course mean that employee contributions would no longer be linked, inextricably, to pension payments at a given level. But just as future entitlements are adjusted by a formula linked to inflation or earnings growth, they could also be adjusted by a formula linked to scheme demographics (but not *national* demographics, which might be quite different).

For the purposes of this paper, the point of such a change would not be to reduce pension entitlements. By accepting the theoretical possibility of longevity-related adjustments, scheme funding requirements would become much less arduous, making it more likely that schemes can remain invested in more lucrative, illiquid investments.

Ironically, as things stand, pensions regulation makes such flexibility impossible – because regulation is framed by the notion of scheme funding, rather than scheme governance. We need to move towards regulation that establishes that schemes are managed in a transparent and democratic manner, and away from the application of evaluation criteria that is inherently contestable.

Yet challenging regulatory norms will not be sufficient to enable long-termism in pension fund investment strategies. Financialisation itself needs to be challenged, so that the private sector's abdicated responsibility for the long term welfare of its employees can be re-established in the UK's business culture. We have too rapidly accepted the emergence of (virtually unregulated) defined contribution pensions as a legitimate alternative to defined benefit. Paradoxically, while the impact of ageing on defined benefit provisions has attracted mountains of expert attention in the last 20-30 years, the most important impact of ageing on pensions provision – the reduction in annuity values within defined contribution provision – has gone largely unnoticed.

As such, we have arrived at quite a perverse moment in the development of the UK pensions system. The possibility that population ageing will make funding private pensions more difficult means that a partnership between employees, employers and the productive parts of our economy has never been more important. Long-termism is the only sensible response to population ageing. Yet we expect individuals alone to shoulder longevity-related risks, in a way that is economically harmful, as well as jeopardising individuals' retirement security.

The limitations of responsible investment

One of the most important changes to the investment environment in the last 15-20 years has been the clamour for responsible investment, embodied and advanced by widespread adherence to the United Nations' Principles of Responsible Investment (UNPRI). This framework assets that sustainable investment returns are dependent on stable, well-functioning and well governed social, environmental and economic systems, and as such 'ESG' issues (environmental, social, governance) should be incorporated into investors' decision-making processes.

However, it is fair to say that this agenda has manifest most of all in support for ethical investment; for instance, disinvesting from arms or cigarette manufacturers, or firms with poor human rights records. While such changes may be welcome from a moral perspective, the link to sustainability is tenuous. Of greater relevance is the trend towards disinvestment from energy firms dependent upon fossil fuels, which has also been an important part of this agenda.

Unfortunately, issues around corporate stewardship have been the most under-developed aspect of the responsible investment framework. For instance, the UNPRI presents the point of stewardship as an opportunity to steer companies away from unethical or environmentally damaging activities – but offers little guidance on what a responsible corporate governance strategy looks like more generally. Yet the practice of responsible stewardship perhaps offers the most potential for instilling long-termism within pension fund investment strategies, in that it equates to pension fund investors working to ensure the long term health of investee companies, rather than focusing simply on short term share values or dividends linked to profits.

The idea that pension funds (or their asset managers) should take an active interest in the companies they invest in through equity ownership has been gaining ground in the UK, with prominent supporters such as ShareAction, the UK Sustainable Investment and Finance Association, and the trade union movement in the form of Trade Union Share Owners. Trade unions in the United States have played an important role in encouraging a long term approach to stewardship among pension funds. However, this is largely due to the funded nature of defined benefit pension schemes in the United States – it would be a regressive step to adopt this approach in the UK, where unfunded public sector pension schemes offer the fairest arrangement for taxpayers and support the state's own role as an extremely efficient long term investor.

One of the coalition government's main initiatives on long term investment was the establishment of the Kay Review of UK Equity Markets and Long Term Decision Making (BIS, 2012), led by economist John Kay. Strangely, the review did not focus on large investors within equity markets, such as pension funds, but rather the role of intermediaries, principally the asset management industry. Although it is of course correct to say that the power (and revenue streams) of asset managers is structurally embedded within capital allocation mechanisms, the assumption that they (alongside investment consultants) are the key decision-makers regarding investment strategies is misguided (Berry, 2014b). As such, no attention was given to determining issues such as scheme design, governance, or regulation. The review also paid little attention to the state's role in structuring the operation of equity markets.

Instead, the review focused predominantly on the conduct of intermediaries. It therefore led to a series of recommendations for stronger self-regulation by the industry – the vast majority of which were supported by the government, and subsequently implemented by industry. The review's most substantive recommendation, regarding the extension of fiduciary duties to asset managers, was rejected by the Law Commission. It is not clear that such a change would have made a great deal of difference anyway – it would be difficult, or impossible, to prove that asset managers ever significantly deviate from the broad mandates set by pension fund clients.

The review strongly endorsed the idea of responsible stewardship, in contrast to frequent equity trading. However, although there is strong evidence of improved performance of investee firms benefiting from responsible stewardship by pension funds, there is is little evidence that this genuinely equates to greater long-termism in business practices. Stewardship typifies the difficulties described in the first section regarding determining what constitutes long term investment. Indeed, insofar as improved performance leads to higher share values, stewardship can in fact fuel herding within equity markets as other investors seek to benefit from share prices rising above-trend (Langley, 2006). Such trends underline the ambivalence of stewardship as a long-termist investment strategy.

In any case, the Kay Review had very much been a Liberal Democrat initiative, under the authority of Vince Cable as Secretary of State for Business in the coalition government. The election of a Conservative majority government probably means that further progress on strengthening the stewardship role of pension funds is unlikely.

Policy options

Primarily, pension funds exist for their members. Generally, pensions regulations dictate that the financial interests of only members matter when it comes to determining how pensions saving vehicles should be managed. Arguably, however, this has been diluted in recent years. Within defined benefit provision, rules associated with employer insolvency and PPF entry mean that employers' interests are favoured over their employees' in certain circumstances, and, within defined contribution provision, there are concerns that the lack of scheme-level governance within insurer-provided schemes creates a conflict between savers and company shareholders.

Moreover, the coalition government's rhetoric on pension fund investments often implied that pension savers – particularly in certain schemes – had an obligation to support government efforts to nurture an economic recovery. All of these developments are regrettable, from a progressive perspective. The UK pensions system is dependent on private saving precisely because its state pension provision is so limited; as such, the interest of scheme members must be paramount in determining how capital is invested.

However, this does not mean that there is no valid reason to recognise that pension schemes may have obligations beyond their members, that is, to the wider economy: their operations rely upon a financial architecture maintained by the state and, more importantly, a significant chunk of their capital comes via pensions tax relief. This section therefore outlines several ways in which synergy between members' interests and an overall economic interest in long term investment may be developed and protected.

Supporting defined benefit provision. The paper has made clear my view that defending and expanding defined benefit pensions provision should be our primary goal, if enabling long-termism in pension fund investment strategies is genuinely desired. Sharing investment risks, involving employers as well as employees, is the most effective way of enabling pension funds to accept the uncertainty inherent in long term investment. I have suggested in the preceding discussion several strategies that might help to support defined benefit provision, including developing multi-employer defined benefit schemes (so that employers may share risks with each other), and making defined benefit provision compulsory (to level the playing field between different firms).

Most importantly, and most controversially, I advocate the introduction of mechanisms for adjusting pension entitlements in light of changes within scheme demographics. This would have a substantive impact on calculations of scheme funding requirements, because funds would know with certainty that, if life expectancy among their members increases significantly, they have the capacity to either reduce expected pension payments or increase pension contributions to compensate, without undermining the property rights of individual scheme members. Cashflow considerations become less burdensome, meaning that, other things being equal, uncertain and illiquid investments become more attractive.

This change would represent a significant dilution of the arrangements for managing longevity risk within defined benefit provision, ostensibly against the interests of scheme members. However, in enabling more lucrative, long term investments, in practice this approach would mean that pension outcomes could be significantly more reliable, as employers are less likely to need to close or restrict schemes.

Collectivising defined contribution provision. It is also possible to make defined contribution schemes look – and crucially, invest – a little more like defined benefit schemes, especially given that their significantly younger age profile (at the moment) should offer opportunities for long term investment. The most immediate priority is ensuring transparent and democratic scheme-level governance throughout defined contribution provision. Where scheme governance is genuinely aligned with the younger demographics, long term investments will, for the time being at least, make business sense.

However, the key to unlocking the potential for long-termist investment strategies within defined contribution provision will be enabling the large-scale adoption of CDC provision, providing for both risk-sharing and self-annuitisation (as discussed above). The coalition government made CDC possible in term of statutory provisions, but the state needs to play a much more significant financial role if employers with individualised defined contribution schemes are to be encouraged to adopt CDC. As things stand, however, it is only employers with defined benefit schemes that are likely to adopt CDC, in order to minimise their risks, which would be a backwards step in terms of supporting long term investment. Certainly, the new government should explore converting NEST into a CDC scheme. Of course, supporting CDC in any form would require that the coalition's pensions liberation reforms are reversed.

Establishing economic renewal funds. Modifying existing forms of pensions saving in the ways envisaged above (even if this were a realistic prospect) will not revolutionise the investment horizons of pension funds. Although some progress is possible, conventional forms of provision are unlikely to be able to embrace the uncertainty inherent in genuinely long term investment. More radical options therefore need to be considered. For example, Ewald Engelen (2006) has suggested a mandatory levy on the surpluses of pension funds to establish locally or sectorally organised funds for economic renewal (justified on the basis of the 'vague ownership' of surpluses, given the significant fiscal support pensions saving attracts). These funds would invest in the long term productive capacity of local economies, or certain high-value industries.

The most obvious limitation of Engelen's proposal is that the existence of fund surpluses cannot be taken for granted (although they would be much more common if funding requirements were reformed in the way I envisage in this paper). More generally, defined contribution schemes, soon to be dominant in the UK pensions system, do not create surpluses. What is required therefore, is, firstly, a nationally organised economic renewal fund. This would *not* be funded by a levy on surpluses, but rather by near-compulsory allocations by all workplace pension schemes (they would have to invest in the fund if they wish to continue benefiting from pensions tax relief on incoming contributions), including both defined contribution and defined benefit schemes. Minimum allocations could be set at a relatively low level (5-10% of fund value), and as such would not significantly disrupt existing investment strategies.

The fund would be sponsored by government, with a mandate to invest in a wide range of long term projects. But it would be run independently, with business, trade union, local government and voluntary sector leaders included within its governance arrangements. Any individual or firm would be free to bid for investment by the renewal fund. The fund would retain an equity stake in any investee enterprise, to ensure pensions savers derive a long term benefit from participation.

Although the national renewal fund would have a specific mandate to invest in projects throughout the UK, this does not mean that local renewal funds should not also be established. The state could again use the carrot of pensions tax relief to ensure that a certain proportion of all pension contributions are invested into a network of overlapping local pension schemes, investing predominantly in the geographical areas where members are based, rather than invested in main pension scheme selected by the employer. A more moderate version of this proposal would see existing pension schemes compelled to develop investment strategies more commensurate with the geographical location of their UK workforce – the Pensions Regulator would be empowered to ensure that schemes meet these requirements.

Introducing investment bonds. A further, specific way in which pension funds could fund long term investment is through 'hypothecated' investment bonds. The state would borrow from pension funds (and other investors) in order to fund specific forms of capital investment, such as infrastructure. Clearly, the state is much better placed than individual pension funds, even if working in concert, to shoulder the risks involved in enormous and very long term investments.

Of course, hypothecated borrowing risks crowding out other forms of borrowing, and leads to the suggestion that *only* long term capital investment is socially useful or economically beneficial, compared to other forms of public spending. However, if pension funds can demonstrate that demand for hypothecated investment bonds supplements demand for existing forms of borrowing, such products may represent an important part of addressing short-termism.

Expanding the state's role. As demonstrated above, there is much that can be done to reform the way that private pension schemes invest. However, instilling long-termism in the UK pensions system may depend most of all on a more active role of the state, or indeed a broader understanding of the state's current role. Most obviously, a state pension set at a higher level would enable more people to take risks when investing their private pensions saving, because their ultimate retirement income is less dependent on the outcome of private investment. The coalition government sought to make private pensions saving make up a greater proportion of retirement incomes (through auto-enrolment and setting the new single-tier state pension at an incredibly low level), thereby instilling risk-aversion within private pensions.

As well as reducing individuals' dependence on private pensions in retirement, the state could also play an enhanced role in hedging investment risks for defined contribution savers by providing annuities (at a much higher rate than offered by the private sector, due to the state's inherent advantages as a risk-hedger). Transforming the annuities market in this manner would enhance the ability of individuals, and those acting on their behalf, to take risks within defined contribution investments, because there would be less uncertainty attached to the annuitisation process.

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