THE INVESTMENT ASSOCIATION

7 February 2020

Rt Hon Sajid Javid MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Representation for Spring Budget 2020

The Investment Association is pleased to submit its representation for your Spring 2020 Budget.

This is a pivotal time for the UK, the companies that do business here, and the people who live here. The first Budget after the UK's withdrawal from the European Union will necessitate careful consideration of the UK's place in the world and the action which needs to be taken to ensure that we remain at the global cutting edge. In this submission, we make proposals which will boost the competitiveness of the UK economy and the global standing of the UK investment management industry. These are ambitious plans to capitalise on the areas in which the UK is already leading, including:

- Implementing the recommendations of the Asset Management Taskforce's UK Funds Regime Working Group to make the UK a more attractive fund domicile.
- A coherent regulatory environment to underpin the Government's ambitions for decarbonisation and climate change adaptation in order to facilitate better management of climate-related risks and opportunities across the UK economy and support a sustainable transition.

It will also be necessary to reduce and remove unforced errors which inadvertently make the UK a less attractive place to do business, adding cost and complexity and potentially disadvantaging our customers. We ask for:

- An urgent review of the funding basis of the Financial Services Compensation Scheme (FSCS).
- A forthcoming consultation to seek stakeholder views on the overall merits of RPI reform and potential impacts on users of RPI-linked instruments before opting to proceed with the change.

This is also the first Budget of this new Government, a Government which secured a mandate in December and has the majority to deliver real policy change which impacts positively on people's lives. While it is essential to consider the UK's place in the world, it is equally important to consider the sort of country we want to be at home. More can be done to boost saving and provide financial wellbeing and we must find new ways to ensure that pension savings can be used to provide long-term, patient capital, helping to level up investment in infrastructure across the UK. We propose:

- Developing the Asset Management Taskforce's proposal for a Long-Term Asset Fund (LTAF) for investing in long-term illiquid assets. The LTAF will help widen access to more illiquid assets, opening up investment opportunities for a range of customers, and providing a new source of much-needed patient capital for the UK economy.

- Strengthening employee share ownership. Increasing employee ownership is an important tool for boosting UK productivity and promoting better employee voice within listed companies.

Many of the proposals in this submission originate from HM Treasury's own Asset Management Taskforce. This is an invaluable forum for government, industry and regulator to identify positive change to provide better outcomes for consumers and boost the competitiveness of the industry. We look forward to continuing this constructive relationship, through the Taskforce and other means, and would welcome a Budget which shows the UK Government backs the UK's world-leading investment management industry.

Yours sincerely,

Chris Cummings
Chief Executive

1. Boosting saving

The IA supports the Money and Pensions Services' UK Strategy for Financial Wellbeing and its five agendas for change. In particular we endorse its ambition that the UK should be a nation of savers by 2030.

Workplace pensions are how most employees save for their retirement over the course of their working lives. Investment managers are involved at every stage of the workplace pensions process, helping people to grow their savings and turning those savings into an income people can live on in later life. Today, three quarters of British households use the services of an investment manager, mostly through their workplace pensions or ISA savings. This number has grown rapidly in recent years as increasing numbers of people are automatically enrolled into workplace pensions – that's 10 million more people since 2012.

Boosting the rate of saving will require a combination of targeted interventions from policymakers – such as auto-enrolment and auto-escalation – as well as joint work between government and industry to make saving more appealing and relevant to people.

From an investment perspective, the industry is working to ensure that there is both an effective and trusted delivery process. Firms are highly focused on ensuring the highest standards of governance and transparency in an ever more competitive market.

There also needs to be greater policy recognition of the importance of investment as the engine room of pension saving. This leads to a number of specific proposals outlined in this submission to ensure access to long-term investment opportunities which will help to drive returns to savers and in turn boost confidence. It also has implications for the design of interventions such as charge caps, which need to balance customer protection with encouraging rather than disincentivising effective investment strategies.

Finally, the pension tax regime needs to works effectively and provide stability for long-term decision-making by pension savers.

Protecting the pension promise

Policy also has a vital role to play in protecting existing pension savings – both for today's pensioners and for those people who are yet to receive their pension. The UK's Defined Benefit (DB) system holds £1.7 trillion of assets to meet the pension promises made to millions of pensioners and workers. DB schemes are major holders of index-linked gilts and inflation-swaps, which are used by schemes to manage their risks and ensure that they can meet their obligations to members.

In holding index-linked gilts and inflation swaps, DB schemes, (and other holders of these instruments, such as insurance companies), are materially affected by the rate of inflation – overwhelmingly the Retail Price Index (RPI) – referenced by these instruments. Any changes to RPI will therefore have a major impact on these investors.

We acknowledge the intention of HM Treasury and the UK Statistics Authority (UKSA) to reform the Retail Prices Index (RPI) to align it with the UKSA headline measure, the Consumers Prices Index including housing costs (CPIH). The impacts are complex and will vary across each individual pension scheme, but an estimate of the impact of an alignment between RPI and CPIH would be a loss in the index-linked gilt market of around £90bn[1].

We are aware of the statistical flaws with RPI and recognise UKSA's statutory objective to promote and safeguard the production of official statistics that serve the public good. However, we are extremely concerned that – given the long run average gap between RPI and CPIH – the potential consequences of such a move could be highly detrimental to DB pensions, affecting both pension scheme members and the employers responsible for funding these schemes.

Recommendation

- The forthcoming consultation should seek stakeholder views on the overall merits of RPI reform and potential impacts on users of RPI-linked instruments before opting to proceed with the change. The consultation should seek views on potential measures to ensure that pension schemes and other affected investors do not lose out from any change. Such mitigation may include amending RPI to align with CPIH plus a margin.

Strengthening employee share ownership

This Government will wish to look at measures which address two dominant economic and political issues: financial inequality and poor productivity growth across the UK economy. There is a growing view that employee share ownership is one such measure which holds the potential to tackle both.

The IA has sponsored the Social Market Foundation (SMF) think-tank to look at the appetite for employee share ownership among employees of listed companies, the potential benefits of increased employee engagement, and possible methods to boost employee ownership. The report will be published ahead of Budget 2020.[2]

The report provides evidence that employee ownership is viewed positively by the public. A survey of 1,000 listed company employees, commissioned by the SMF, found that:

- 68% said that they like the idea of holding shares in the company that they work for.
- 60% believe that employee shares/options would incentivise them to stay with their employer for longer than originally intended.
- 58% agreed that share ownership would/does make them "more motivated to do well in my job". This suggests that employee share ownership could improve workforce productivity.
- 56% said that employee share ownership would make them more interested in other types of investment – suggesting that it can encourage individuals to engage more with savings and investment products.
- 46% of those surveyed that held employee shares/options said that they did so because they expect shares to increase in value in the future. 42% said they did so as another way to save/earn money, and 36% said they held shares to benefit from dividend payments.

Expanding employee share ownership could provide a financial boost to UK households, especially where individuals currently hold excessive savings in current accounts or low-return instant access savings accounts. Wider distribution of ownership would enable employees to participate in the economy not only as consumers and workers but also as owners of capital.

Employee share ownership also has the potential to contribute to improvements in productivity across the country. In 2016, the Employee Ownership Index showed that listed companies which have at least 3 per cent of their share capital held by employees (or on employees' behalf)

[1] Insight Investment, Proposed Changes to RPI, November 2019
[2] Social Market Foundation, Strengthening Employee Share Ownership in the UK, February 2020

outperformed firms in the FTSE All Share in ten out of the previous thirteen years by an average annual margin of 13.9%.[3]

Recommendation

- We ask that the Government begins work looking at potential measures to strengthen employee ownership. Any approach must ensure that schemes are structured in a manner that reflects the affordability constraints and risk appetites of workers. This might favour share option schemes over simply encouraging employees to buy company shares. The approach should also reflect the ownership rights of existing shareholders, many of whom are ultimately ordinary pension savers.

2. Patient capital and infrastructure investment

Infrastructure investment is the backbone of the British economy. It's the funding for roads and railways that keep passengers – and businesses – moving; the energy we use every day; and the new homes, schools and hospitals we all rely on.

Much of this private capital invested in infrastructure ultimately comes from ordinary savers' pensions and ISAs, which investment managers channel directly into projects and into the companies which build them. This benefits the savers who want to receive stable long-term returns on their investments, and all the users of the infrastructure that this funds.

Around £35bn is channelled into British infrastructure each year by investment managers. This is particularly significant in some crucial parts of the infrastructure landscape, for instance there is £6.7bn of capital markets finance invested in social housing, the largest single source of finance in this area.

This figure could be much higher. Today, not all pension savers can invest in assets such as infrastructure and housing (rather than stocks and shares). It also means that the economy can't fully benefit from large pools of capital which could be used to boost productivity. Changing this means focusing more on the ultimate outcome that everyone wants from their pension – investing in assets that could provide stable growth over the long-term.

Recommendations

- Implement the Asset Management Taskforce UK Funds Regime Working Group's proposal to introduce a **Long-Term Asset Fund (LTAF) for investing in long-term illiquid assets**. The LTAF will help widen access to more illiquid assets, opening up investment opportunities for a range of customers, particularly those saving in Defined Contribution (DC) pension schemes over many decades. As well as supporting savers, it would open up a new source of much-needed patient capital for the UK economy.

- Support the joint proposal from the IA and the Association of Real Estate Funds (AREF) for a **Professional Investor Fund to allow pension funds and other professional investors to invest in real estate and infrastructure** through an unlisted, tax transparent fund structure with tradeable units which is not required to operate as an Authorised Fund. No such fund structure currently exists in the UK, meaning UK investors must use overseas funds for this purpose.

- **Provide stability in the pensions charging regime to give pension schemes the confidence to invest in assets such as infrastructure** (which may involve higher costs but generate a greater long-term return) or reduce risk through diversification. As the DC pensions charge cap is reviewed this year, we call on the Government to avoid reducing its

[3] UK Employee Ownership Index, https://bit.ly/31wSbHl

current level or bringing transaction costs within its scope. Making it easier for schemes to account for performance fees within the cap will also widen the range of asset classes that schemes can access, helping improve member outcomes. Concerns around future reductions in and changes to the structure of the cap reduce the incentive for pension schemes to invest in infrastructure and other alternative assets and embeds a mind-set in the market that ignores value, equating quality with lowest cost.

- Government can further aid the ability of DC pension schemes to access alternative asset classes by **ensuring its commitment to a successful conclusion of the FCA's consultation on changes to the 'permitted links' rules for DC schemes investing in unit-linked funds.** We have previously made a series of proposals in response[4] to the FCA's consultation, which, if implemented, we believe will make a significant difference to DC schemes' ability to access alternative asset classes.

3. A globally competitive investment management industry

As the UK leaves the EU, the UK Government will need to look wider than the existing and future economic relationship with our near neighbours. For the UK's leading industries to thrive they will need to maintain a competitive edge, identifying new areas for innovation and removing barriers to improvement.

The same is true of the policy environment, with the Government and regulators ensuring they adopt a mind-set which fosters the development of products and services which consumers need and demonstrates to the world that the UK is a country in which talented people and leading, forward-thinking businesses can thrive. We welcome reaffirmation of the Government's commitment to the Asset Management Taskforce, of which the FCA is an important and valued component.

The first Budget of this new Government is an opportunity to reflect on existing measures which may have been hampering investment and the development of a talented workforce.

<u>Recommendations</u>

- We ask that the Government **asks the independent FCA to consider how it achieves its current regulatory outcomes more efficiently** and with lower overall cost and burden on supervised firms. Sending a signal that the UK welcomes and supports international and home grown financial services businesses which seek to serve UK consumers. A cost-benefit analysis of cumulative impacts to assess the overall volume of interventions on individual industry sectors and more consistent post-implementation reviews would help to achieve this aim.

- **Implement the recommendations of the Asset Management Taskforce's UK Funds Regime Working Group** to make the UK a more attractive fund domicile. This includes measures which will help to promote the UK's competitiveness in the professional investor space, the creation of a single FCA rulebook for the investment industry to make it easier for investors to understand the UK regulatory regime, and a range of measures to ensure that investment funds can be used more effectively in the retirement income market. These include possible areas for fund innovation in retirement products, measures to enhance tax efficiency of funds for retirement savers and wider issues such as the consistency of disclosure across different product sets.

- In order to facilitate better management of climate-related risks and opportunities across the UK economy and support a sustainable transition, we need **a coherent regulatory**

---

[4] IA response to the FCA CP18/40, https://bit.ly/3bhiMg9

environment that underpins the Government's ambitions for decarbonisation and climate change adaptation. Such an environment will empower investment firms to take investment decisions that are geared towards sustainability and help to manage the risks that savers are exposed to as a result of climate change. This would include clarity on the timing and nature of regulatory measures that need to be introduced to facilitate the transition to zero carbon emissions by 2050. Specifically, we would encourage the Government to issue green gilts, linking this issuance to measures that contribute to the target of being net zero by 2050. Government policy should take a joined up approach across the investment chain (from savers, asset owners, investment managers, through to investee companies) to ensure that climate change-related considerations are meaningfully factored into the investment process.

- An urgent review of the funding basis of the Financial Services Compensation Scheme (FSCS). Our industry remains convinced of the need for a compensation scheme that can support customers who have been let down by the actions of individual firms. The investment management industry's annual levy contribution to the FSCS has increased from £2m in 2016/17 to £133m in 2019/20 and a forecast £200m in 2020/21. Such costs impact on the attractiveness of the UK as a place to do business. We advocate the principle that the 'polluter pays' and are concerned that soundly run businesses are increasingly being asked to fund the failed business models, and regulatory failings, in businesses over which they have neither insight nor control. The IA has convened a working group to consider the calculation methodology of the levy and whether there are alternative transparent methods that are easier and fairer to operate and which will allow the FSCS to continue its work protecting vulnerable and missold customers. We recommend that an urgent review is established to re-examine the funding basis of the FSCS and ask that it considers the finding of the IA working group.

- The time is also appropriate for a review of the effectiveness of the Apprenticeship Levy. The current framework is not well suited to the recruitment and training practices which are common and appropriate for the investment management industry. In the first 12 months of the levy, our industry reported that it would pay in total approximately £10.9m and receive back about £180,000, a ratio of 61 to 1. While the industry has worked to improve its ability to access levy funding, we know that there is still a significant shortfall in the funding accessed to offer high-quality apprenticeships in investment management. We understand that this policy will be reviewed this year and the IA is committed to working with HM Treasury to be a pilot sector for more flexible and effective application of the levy.

- It is important to ensure that the UK does not erect new obstacles to investment with our biggest economic partners. We encourage HM Treasury and the Home Office to review the Proceeds of Crime Act (POCA) to allow investment in companies producing or selling products derived from cannabis in markets where this is legal. POCA is an extremely important piece of legislation ensuring that criminal funds do not enter the mainstream financial system but at present it could criminalise investment in mainstream consumer goods companies listed on the New York Stock Exchange.

A competitive tax regime is a key driver for achieving a globally competitive position. The IA supports the Government's commitment in the UK Investment Management Strategy II, published in December 2017, to "deliver and promote a stable and competitive tax and regulatory environment" for investment management.

Recommendations

Maintain existing features of the UK tax regime:

- Maintain its commitment to a competitive corporate tax rate. In our experience the low headline rate is a significant factor in investment decisions.

- **Maintain and continue to develop the UK's safe harbour rules** (under the Investment Manager Exemption as well as the "investment transactions white list" for funds) which allow funds to be managed from the UK without the risk of additional UK tax liability at the fund level.

- **Maintain and further broaden the UK R&D tax credits regime** that provides for tax benefits for qualifying research and development costs encouraging innovation in businesses.

- **Maintain a competitive UK personal tax regime** to retain and attract talent, particularly expats. The UK investment management industry relies extensively on availability of highly skilled and internationally mobile workforce. More evidently in the current climate, foreign tax regimes are offering generous tax incentives to attract talent and therefore businesses to establish and enhance their presence in these countries.

Enhance the UK tax regime:

- **A portfolio exemption from UK capital gains tax for non-resident investors in UK Property**. The introduction of capital gains tax for non-residents invested in UK property has overlapped with the UK property fund sector's continued struggles over the last number of years. While the overall policy aimed to ensure consistency of tax rules between UK and non UK investors in UK property, the new rules have resulted in UK property invested collectives becoming unattractive on the international stage. Global share trading platforms have begun to remove UK property rich entities caught by these changes and this has closed off a key avenue for FDI which has further depressed an already struggling commercial property market. This sits in contrast to other countries like the US and Australia which offer relief from incidental holdings in their own property markets.

- **Proportionate implementation of DAC6.** As the EU directive on administrative cooperation in direct taxes for disclosure of cross-border arrangements ('DAC6') has now been incorporated into UK law, member firms have begun to look at the practical considerations of how the rules affect them and their businesses. We seek to continue the essential and invaluable dialogue we have had with HMRC around areas of concern and ensure that any undue reporting burdens for both the industry and the HMRC are proportionate and that any guidance is clear and focused on overall intent of the Directive.

- **Support for carve outs from Pillars One & Two of the OECD's Taxation of the Digital Economy**. As public concern around the tax contributions of large scale digital firms grow, we believe it is important to ensure that the scope of the OECD's Pillar One proposals is suitably defined in line with the policy intention of targeting consumer facing digitalised business models. Investment management and wider financial services businesses do not fit the model of proposals predominantly due to the whole sale markets that they operate in, heavy regulatory requirements and deeply local presence rather than remote selling. Additionally, investment funds need to be out of scope as funds and other investment vehicles serve a wider economic purpose supported by the government policies.

  On Pillar Two Global Anti-Base Erosion (GloBE) proposals, we are seeking an explicit carve out for investment structures including collective investment vehicles (CIVs) and similar investment pooling vehicles (non-CIV funds). Investment structures provide important funding routes and liquidity for the capital markets. The Investment Management industry plays a major role in the global economy, ensuring that capital markets work effectively. Globally the industry manages £59 trillion of assets, demonstrating the enormous size of the industry, which has historically been at the heart of long-term capital allocation. A failure to exclude investment vehicles from the proposals would reduce investment returns by adding an additional layer of tax, introduce unintended distortions into the capital markets and for individual investors (whether direct investors or as beneficiaries of pension funds and life insurance policies, for example), would further reduce incentives to save.

In line with our consultation responses to the OCED proposals[5], we seek Treasury's continued support in lobbying for a general carve out for financial services (which should include investment management businesses) from Pillar One proposals as well as an explicit carve out for investment structures from both Pillar One and Pillar Two proposals.

- Brexit and maintaining the fund industry's access to agreed treaties. It is imperative that the UK continues to maintain its competitive advantage globally with its network of double tax treaties as we leave the European Union. As UK Funds will no longer be categorised as UCITS or indeed EU vehicles post-Brexit, it should be stressed that during the future relationship negotiations that, where possible, access to domestic law exemptions from withholding tax within the EU should be made available, and equivalence is pegged to local fund structures to ensure a level playing field going forward.

  More broadly, specific attention should be given to protection of treaty access rights of UK funds while negotiating and renegotiating treaties as well as while agreeing Competent Authority Agreements. In recent years, administrative obstacles introduced by a number of countries have resulted in eroding the treaty entitlement of UK funds which further adversely affects the competitiveness of UK funds.

- Remove the tax inefficiency of UK funds. While the tax regime of UK equity or bond funds offers tax neutrality at fund level, UK multi-asset funds or balanced funds in many cases end up suffering a UK tax charge unlike non-UK funds. This not only make such funds less favourable for investors but also has the effect of undermining the tax effectiveness of the wider UK funds tax regime when compared to other overseas fund regimes. With the growth of UK DC accumulation and capital markets, the use of multi assets funds is expected to grow further and addressing the tax leakage for these funds will help bring UK funds on a level playing field with offshore funds.

  Additionally, the tax regime for any new UK fund vehicles or fund structures should be carefully designed to ensure tax neutrality at fund level with timely consultation with the industry.

- Review of the UK VAT Regime in a global context. A competitive VAT regime that allows businesses to effectively manage their VAT costs is a vital consideration. VAT can be a significant cost to UK-based fund managers when managing UK funds, disproportionately impacting business decisions. There are two distinct aspects therefore that need to be addressed:

  a. A more consistent and comprehensive application of the current VAT exemption for Fund Management - The definition of what constitutes 'management' has been subject to significant amount of litigation and the recent court decisions have provided more guidance on how it should be interpreted particularly in the context of outsourced functions. However, there is an urgent need for HMRC to give the proper effect to such case law so that for those supply chains that ultimately relate to a special investment fund, no additional VAT cost is suffered purely for the reason that certain functions necessary for the operation of the funds are outsourced.

[5] OECD, Pillar One response: https://bit.ly/39fqqWL; Pillar Two response: https://bit.ly/2GSpX0d

b. Maintain a competitive VAT environment for UK based asset managers by continuing to apply VAT exemption / outside the scope with recovery (OSR) treatment to management of all existing and new fund structures.

4. EU Exit

The UK has now left the political structures of the EU and is on course to change its current economic relationship by the end of 2020. The shape of the future relationship which the UK Government negotiates before the year end will be crucial to defining the nature of the UK's future economic mix.

No 'off-the-shelf' model will fully replicate the features of the EU's Single Market passport for our industry. The future relationship between the UK and the EU will need to account for political realities of Brexit and leaving the EU. The IA urges against any significant reconfiguring of the UK/EU economic relationship in a manner which would restrict the ability for investment managers to serve savers and investors wherever they are located, or access to critical market infrastructure.

While language, time zone, and the UK's stable legal system have helped to cement its status as an international investment hub, the ability to provide products and services on a cross-border basis between the UK and the EU has been integral to the industry's recent growth. Over the past decade, assets under management in the UK have grown from £4.7trn to £7.7trn, with many international firms locating their European headquarters in the UK, and UK/EU capital markets deeply integrated at almost every level.

We ask that HM Treasury delivers a Budget which allows for a future relationship that maintains the close economic relationship between the UK and the EU. It should remain the priority of the Government that the future relationship is underpinned by sincere and structured supervisory cooperation.

Recommendations

- **Safeguard the ability to offer investment products and services between the UK and the EU.** Given the already high degree of UK/EU regulatory alignment, and the extensive onshoring of all EU acquis into UK legislation during 2018 and 2019, the priority in the next phase should be securing early and unconditional equivalence determinations across the existing range of third-country regimes, specifically Article 46 of MiFIR, and on data adequacy under GDPR.
- The UK should in any case **bring forward domestic legislation to provide a streamlined route into the UK for EU-domiciled funds** to preserve the access of UK consumers to high quality investment funds, including specialist products not otherwise offered in the UK such as ETFs and MMFs.
- **Offer certainty over the process underpinning market access.** The IA seeks clarity on the process for determining and withdrawing equivalence to provide firms with greater confidence about their ability to operate cross-border. The Government should secure an agreement that equivalence determinations be based on regulatory outcomes, rather than a line-by-line test, to future proof such determinations as the new relationship matures, and include a precise, independent mechanism for the resolution of disputes and technical mediation.
- **Provide the UK with a strong voice in the development of regulation.** The IA seeks an EU-UK regulatory forum with specific governance and procedures, and commitments on regulatory coherence and supervisory cooperation to ensure the close and structured cooperation on these matters between the UK and the EU is maintained. Any such arrangements should be constructed with full recognition and acknowledgement of the

fundamental change in status for the UK from having been a Member State, with the associated benefits and privileges, but also in a way that is fully cognisant of the historically close and trusted working-level relationships between UK and EU authorities.

- Protect the position of the UK as a leading international financial services hub. While Brexit represents an opportunity to enhance the UK's position as an internationally competitive investment management centre, this should not compromise the delegation of portfolio management activity to UK investment managers from EU-domiciled investment funds.