

Pension deficits are an issue but the real problem is t...

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As the [FT notes this morning](#):

UK companies reporting annual results for the year to March are expected to report an increase of more than £100bn in their aggregate pension scheme deficits, according to actuarial forecasts.

This year's reporting season is likely to expose larger, not smaller, pension shortfalls than existed a year ago, despite sharp rises in stock and bond markets where retirement schemes have invested their assets.

That is because investors, including pension schemes, have [piled into corporate bonds](#) in recent months, seeking higher yields than those on risk-free debt.

The effect of all that buying has driven down yields on high-quality corporate debt that are used to calculate corporate pension liabilities that show up on company balance sheets. The lower the interest rate used to discount the value of future pension promises, the higher the current level of liabilities.

And so the mad merry go round of large company pensions being invested in large companies who can't meet their pension obligations goes on. It's very hard to see this is anything else but MAD - Mutually Assured Destruction.

There is an alternative. I wrote it with Colin Hines in our paper '[Making Pensions Work](#)'. As we explain in that report:

99% of all investment in corporate shares and bonds made by pension funds is in what might best be called "second hand" shares or bonds already in issue. The purchase or sale of such shares or bonds provides the issuing companies nominally responsible for these assets with no direct benefit at all from their purchase. It was of course true that when first issued such shares and bonds would have provided funds to the company that issued them, and whose name they bear, but thereafter whenever they are bought and sold — as they are day in, day out by pension funds — not one penny of the money traded goes to the benefit of that company. Instead all of it goes to the

previous owner of the share or bond in question. That may be a pension fund, of course, but the point is that none of this speculative activity does in any way benefit the productive economy. As such a pension funds purchase of these assets creates no new investment or employment opportunities. In economic terms these pension fund "investments" are, therefore, savings activities and not investment activities.

In other words; pensions are not invested. And since large companies aren't investing either right now, pension money is in effect being poured down a giant sink. That's despite some £80 billion a year going into pensions and the subsidy to the pension sector, when we prepared our report, being some £38 billion a year from the state - despite which it still could not make a positive pension return (which shows just how bad they are at what they do).

That's for a good reason. As we explained, the existing pension model is fundamentally flawed:

The reform of pensions required at this time must be based upon recognition of the fundamental pension contract that exists within any society. This is that one generation, the older one, will through its own efforts create capital assets and infrastructure in both the state and private sectors which the following younger generation can use in the course of their work. In exchange for their subsequent use of these assets for their own benefit that succeeding younger generation will, in effect, meet the income needs of the older generation when they are in retirement. Unless this fundamental compact that underpins all pensions is honoured any pension system will fail.

This compact is ignored in the existing pension system. Indeed, the current pension system does not even recognise that it exists. Whilst state subsidised saving for pensions is undoubtedly taking place there is no link between that activity and necessary investment in new capital goods, infrastructure, job creation and skills. As a result state subsidy is being given with no return to the state appearing to arise as a consequence, precisely because this is a subsidy for saving which does not generate any new wealth. This is the fundamental economic problem and malaise in our current pension arrangement.

In the meantime, and as importantly, a massive but unproductive industry in managing pensions funds has been created, which enormously reallocates wealth to the City of London but which appears unable to pay any adequate pension returns.

No surprise at the end there, of course. It's ever thus in our economy. But this has to change, and it could. As we argued:

Most importantly we suggest that if those pension funds are to attract tax relief in future they must use a significant part of the £80 billion of contributions they receive each year to invest in new jobs, new technology and new infrastructure for the UK so

that the wealth that is needed to grow our economy, to create jobs and to build the real capital base that must be passed to the next generation is built on the back of pension fund investment.

Next we suggest radical improvements in the transparency of pension funds so that all pension investors can hold them to account for the use of the money entrusted to their care — something that is impossible to do at present.

Thirdly, we recommend that current pension deficits in final salary schemes be cleared wherever possible by the issue of new shares in the companies responsible for those funds. This would stop the current fruitless drainage of cash out of companies that should be used for real investment and which is instead directed via pension funds into the stock market to buy shares in other companies, the only benefit of which is to create a spiral of stock exchange boom and bust. We also suggest that future contributions to such final salary pension schemes might also be paid, at least in part, by issuing new shares in the companies responsible for those final salary pension schemes. This would free cash within those companies for real investment in real products and services that create wealth in the UK economy. The benefit of that investment in new products and services would then be shared with the people working in those companies as a result of the mutualisation of their ownership via their pension funds.

Lastly we recommend that if enforced saving is to be required by the government then that government has a duty to ensure that the funds so saved are invested for the common good.

Pension fund performance over the last decade has been a history of almost perpetual loss making despite the enormous subsidies that pension fund tax relief has provided to the City of London and stock markets, all of which they have frittered away. Investment in local authority bonds for local regeneration, or in bonds or shares issued by a new Green Investment Bank and in hypothecated bonds e.g. to provide alternative funding to replace the inefficiently expensive Private Finance Initiative for funding public sector infrastructure projects would have prevented those losses — because all of these would have paid positive returns to pension fund investors. It is for exactly this reason that we recommend that such assets be the basis for any new state pension fund in the future.

The impact of our proposals would be significant. At least £20 billion a year would be released into the UK economy for new investment.

People would understand what their pension funds were doing, and could hold them to account for it.

State subsidies to pension funds would produce real economic returns for the government.

And the incentive to save in pensions would be real — because people would see the benefits of

doing so for their immediate well being, for their own future income and for the benefit of their children.

Pension deficits are an issue, but the real problem is the lack of effective thinking about pensions. That's the deficit that has to really be addressed, and soon. I'd suggest Colin and I have made a start, but real debate is needed on a vital issue - costing the UK £38 billion a year - and that's really not happening right now.