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Are you ready for the new-look UK retirement market?

Both domestic and international asset managers are excited about an unparalleled opportunity. Here's a primer on the changes remaking the market.

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The UK retirement market is undergoing profound change. For the past several years, technological change has been brewing and customer preferences shifting. Now, new regulations are taking effect. All these forces are coming together to create an opportunity for asset managers that may be unique in Europe; no other market has so many assets up for grabs. But with so much changing at once, grasping the opportunity is by no means straightforward. In this article, we examine the factors driving change and outline six actions that asset managers can take to capture a bigger share of the assets that are newly available.

A market in play

We estimate that total retirement assets¹ in the United Kingdom amount to about £3.9 trillion (Exhibit 1). Of this, about £155 billion is in motion each year, as workers and employers make contributions and

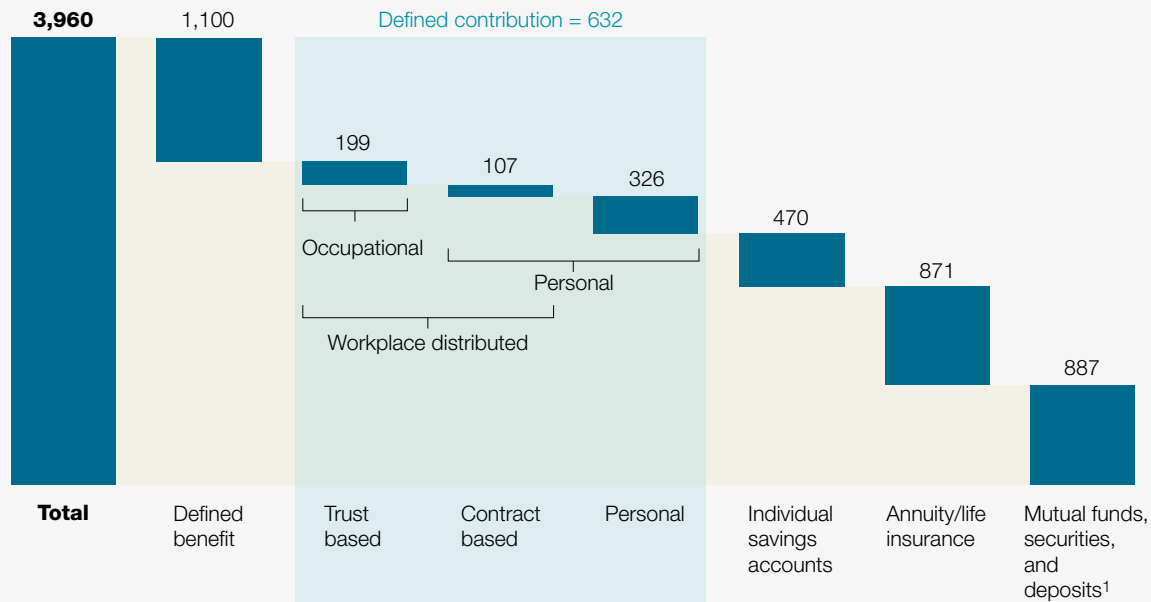
pensioners (about ten million at present) draw down on their savings. That figure is about to expand. Our analysis of the various factors—changes in regulation, distribution technology, and customer preferences, all explored in more detail in this article—suggests that the money flowing into and out of the retirement pool will grow to about £180 billion by 2020. Asset managers are particularly interested in the moment of retirement, when we expect that about £8 billion to £10 billion annually that used to move into insurance products will be accessible to these players.

New rules

In March 2014, the Chancellor of the Exchequer announced the 2014 budget, which included new rules for pensions. In March 2015, the new budget clarified the rules, especially with respect to annuities. About 4.2 million British savers over

Exhibit 1 UK retirement assets are at about £3.9 trillion.

UK retirement assets, 2013, £ billion



¹We made age-based assumptions of the share of assets held against retirement (ie, people up to 44 years old hold on average 25% of those assets as retirement savings, those 45–64 hold 50%, and 65 and older hold 100%); based on McKinsey Global Banking Pools.

Source: Financial Conduct Authority; Office of Fair Trading; Spence Johnson; McKinsey analysis

the age of 55 now have more freedom than ever before to manage their retirement pots.

Previously, the rules forced people to buy an annuity when they retired. The new rules allow them to withdraw lump sums or stay invested. That will favor asset managers and their investment products. Customer research conducted shortly after the announcement indicated that only one in three people aged 50 to 75 intended to buy a traditional annuity—and then only for a portion of their assets. If this shift bears out, with annuities relegated to the role of covering basic expenses and other products used for discretionary assets, we estimate that annuities’ share of in-retirement products could decline from the current 75 percent to about 30 to 40 percent. That equates to about £8 billion to £10 billion annually.

On the accumulation side, defined-contribution plans are a bright spot, with more than £630 billion of assets and £1 billion of profits. The United Kingdom is the largest defined-contribution market in Europe and is forecast to grow by about 10 percent annually over the next five years, driven mainly by a rise in the number of retirees. Autoenrollment, another recent rule change, is taking effect in phases. Although it is going through some growing pains, autoenrollment is expected to add an additional £8 billion to £12 billion to the current £78 billion in annual workplace pension contributions by 2018—an increase of about 10 to 15 percent. And defined-benefit plans continue to convert to defined contribution.

Other rule changes will also affect the market. In 2014, the UK government banned companies from

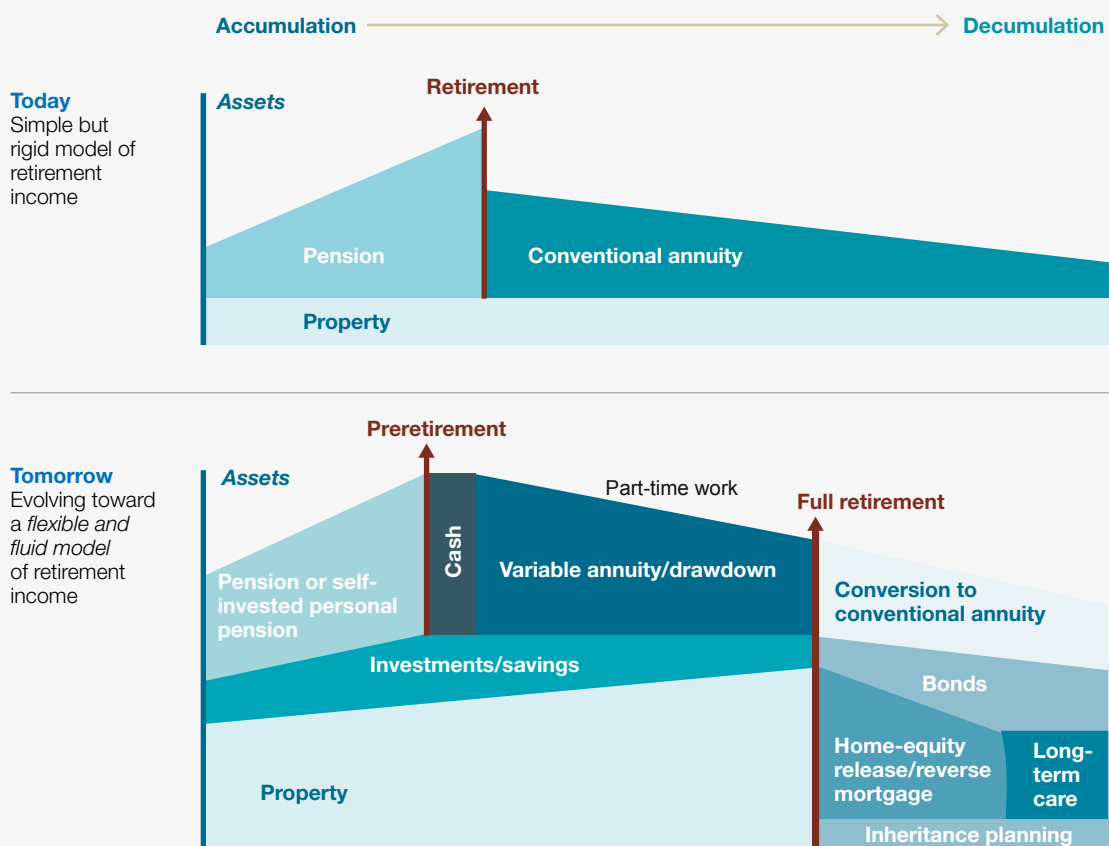
imposing a compulsory retirement age, except in certain circumstances. As a result, more individuals may now continue to work part-time, pushing out their retirement age. This will strengthen an ongoing trend: the number of people over 65 and still working has doubled in the past 15 years and is expected to continue growing. As customers shift away from one-time decisions (for example, buying an annuity at 65) to a more prolonged and engaged decision process, opportunities will arise for providers to interest customers in other products, such as long-term care, home-equity release, and fixed-income solutions. Exhibit 2 lays out how the retirement-product mix might shift.

One final regulation bears mentioning: the Retail Distribution Review. The rule addresses the lack of transparency in the dealings of this heavily intermediated market by ending behind-the-scenes commissions and making fees visible to customers. The impact of this regulation is still unfolding, but some things are becoming clear.

Distribution disruptions

Changes in distribution have been simmering for some time. Platforms—the systems used by asset managers, pension providers, and others—are becoming more sophisticated; technology is now

Exhibit 2 The product mix will shift significantly over time.



Source: Capita; Cazalet Consulting; *Money Management*; McKinsey analysis

used to steer customer decisions. More changes are on the way. Given the similarities among these electronic offerings, as well as the pressure on providers' economics, many will choose to further modernize their platforms. This should help in creating seamless, end-to-end experiences that guide self-directed customers. Pension providers may also consolidate assets, which would give customers broader offerings that embed some forms of advice. In general, there is consensus among many that platforms will become even more critical influencers that drive planning and investment choices.

Another big change is the expansion of direct-to-customer models. Digital distribution of financial products is already commonplace in the United Kingdom. Multichannel banking is widespread, if not quite as prevalent as in the Nordic countries. At the current rate, we expect UK digital distribution to reach maturity in the next three to five years. For example, the share of direct distribution in life insurance is about 10 percent today, and it is forecasted to reach 15 to 20 percent by 2020. Similarly, the share of retail-investment funds sold through direct-to-customer platforms such as Nutmeg has been growing at about 10 percent annually, a trend we expect to accelerate.

Digital direct-to-consumer models can disrupt the retirement market in many ways, including digital advisory and the rise of new intermediaries. These new companies can carve out a niche, unencumbered by channel conflicts and legacy operations and IT costs.

One thing that is not changing much is that bundled models appear to be maintaining their popularity, unlike their US cousins, which are losing ground to defined-contribution investment only.

The changing customer

Savers' preferences are also evolving, partly in reaction to these shifts in distribution. We surveyed 2,300 British savers and pensioners in March 2015

and found that despite the public debate on pension overhauls, awareness of retirement solutions is generally low. Only 50 percent of people over 50 are aware of the changes affecting annuities. Product understanding is also generally limited; about 30 to 40 percent of British customers do not understand the value proposition of drawdown products (Exhibit 3). Savings rates have rebounded to pre-crisis levels, and people are once again eager to get guidance—but they have limited appetite to pay for it. More than 40 percent of customers say they won't open their checkbooks for this service. That's a problem, as the Retail Distribution Review, in a bid for transparency, has shifted the burden of paying for advice to the customer.

Instead, customers look to their employers as their primary source of retirement information, leading to new opportunities in workplace distribution. About 20 percent of people turn first to their employers for retirement advice, even though most employees do not understand their workplace pension that well. Over time, customer expectations are likely to rise. Already, about a third of employees state that their employers' pension schemes are a key reason to remain in their current jobs. Pensions are also becoming more relevant for recruitment efforts, though they are not yet as critical as health benefits.

Between their unwillingness to pay and the sometimes competent but often narrow advice they get from their employers, middle-class customers still have significant unmet needs. Pensions and equity individual savings accounts are the two financial-product categories where people want most advice. Customers are also not yet fully comfortable with self-service solutions such as the emerging robo-advisers.

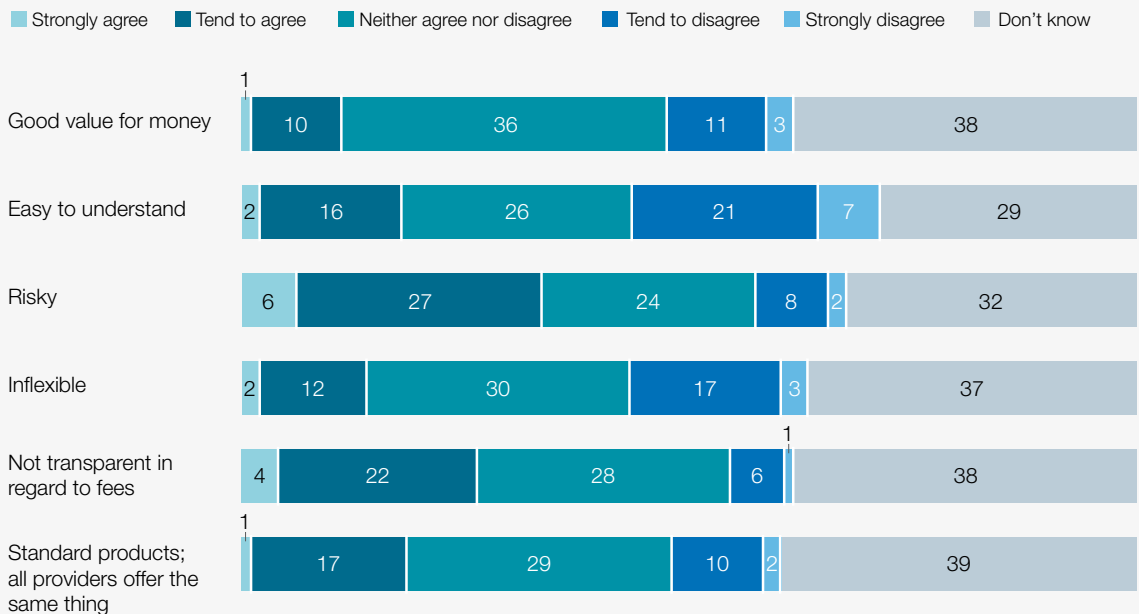
How to approach the market

With everything in flux and assets seemingly there for the taking, managers are eyeing the UK market with interest. Indeed, some international players are talking about entering or reentering it.

Exhibit 3 Customers have a poor understanding of drawdown products.

To what extent do you agree with the following statements regarding drawdown products?

% of respondents¹



¹n = 2,300; figures may not sum to 100%, because of rounding.

Source: McKinsey analysis

The enthusiasm is tempered, however. Asset managers know that capturing these shifts will be difficult. Many have tried recently. Consider workplace distribution—a clear opportunity but an elusive one. Using an institutional relationship to launch up- and cross-selling of individual financial products to employees has proved notoriously difficult in both the United Kingdom and other major defined-contribution markets. Or take middle-market advice, a heavily regulated and difficult business. To avoid running afoul of the rules, many managers offer packaged information rather than advice per se. But such “productized” advice has limits and will be a tough challenge for retail providers.

In the face of these uncertainties,² many players are proceeding cautiously. Strategic exploration and targeted pilots, such as investments in digital

distribution and various financial-technology start-ups, are the order of the day. We argue that these moves, however useful, are not enough. We see six opportunities for asset managers to improve their distribution, value proposition, and operations. The window created by the confluence of sweeping changes is necessarily limited; actions that providers take in the next 12 months or so will likely set their course for years to come. In brief, the six opportunities are as follows:

Distribution

- Build a *direct-to-consumer channel* for execution only—or at most for providing simple advice. A critical success factor here is traffic generation, including the use of various digital-marketing vehicles and online partnerships. Managers with experiments in progress

should push them harder and faster, and others should enter the fray.

- Partner with employers and employee-benefit consultants to build better *digital interfaces* and associated services that help employees manage their defined-contribution plans. Such workplace solutions might help employees roll up the various plans they hold with different providers, as well as assist with the purchase of other individual products and broader employee benefits. One manager is successfully selling individual savings accounts from its clients' intranets along with pensions.

Value proposition

- Drive growth in the *small and midsize defined-contribution pensions segment* by setting up master-trust structures and creating low-cost, functional self-service solutions. This segment is growing faster than others, and the master-trust structure allows for new economies of scale.
- Develop a *holistic retirement proposition* that serves individuals to and through retirement, including a broad product suite, distinctive service anchored in deep customer insights, and multichannel delivery. This includes *fit-for-purpose nonannuity products* (for example, drawdown with annuity-type features such as outliving riders) or life-cycle product structures that follow customers beyond their retirement dates, potentially accommodating variations such as partial retirement. Seamless customer experience is critical, as evidenced by leading US providers that have mastered the art of capturing rollovers from defined-contribution plans to individual retirement accounts. Examples of smooth rollover processes include one-click account opening, fast-tracked processing of internal rollovers, systematic customer outreach at life events that trigger a financial decision, and automated identification of clients at risk.

Operations

- *Drive down costs by 15 to 30 percent* to preserve competitiveness in a transparent, regulated, fee-based, and fee-capped environment. Savings of this magnitude will likely require addressing the full range of efficiency levers: front-to-back digitization, distribution transformation, and lean operational practices.
- *Pursue M&A opportunities* to add new capabilities (for instance, digital capabilities) or scale. At-scale providers enjoy operational efficiencies and can use their institutional relationships with employers to drive individual product sales. ■

¹ Including pensions, individual savings accounts, annuities, life-insurance products, and select other savings (for example, securities).

² These uncertainties continue to multiply. In July 2015, the UK government announced it may consider taxing pension savings at the time of saving and not at the time of disbursement. That could affect current trends, in which flows are accelerating toward asset managers and away from life-wrapped products.

This article was adapted from the authors' white paper, *In the eye of the storm: Transformation in the UK retirement market*, April 2015, mckinsey.com.

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