

In the Eye of the Storm: Transformation in the UK Retirement Market

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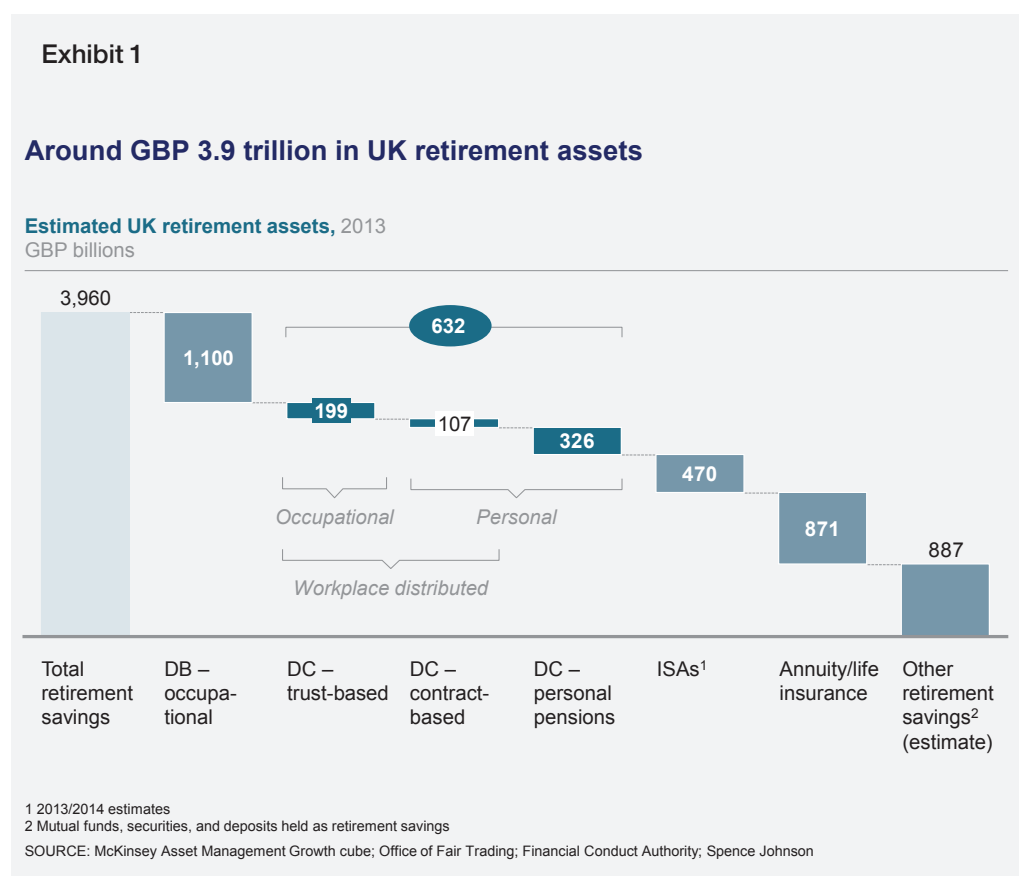
In the Eye of the Storm: Transformation in the UK Retirement Market

The UK retirement savings and decumulation market is undergoing profound change across all dimensions: regulations, technology, competitive dynamics and customer preferences. The result is an opportunity for capturing market share that is unique in the broader European asset management landscape, and which has prompted an unprecedented level of strategic debate among the asset managers, insurers, pension providers, platforms and distributors that operate in the sector. They are grappling with questions such as: How should life insurers protect their annuity businesses? How to compete – or partner – with the fast-growing platforms? Are we facing the next wave of M&As?

This paper outlines McKinsey's views on the market dynamics of the UK retirement landscape and describes specific strategic opportunities for asset managers and life insurers seeking to grow in the market.

£3.9 trillion in retirement assets

McKinsey defines retirement savings broadly as funds specifically earmarked for old-age expenses. This includes pensions, independent savings accounts (ISA), annuities, life insurance products and select other savings (e.g., securities). By this definition, total retirement assets in the UK are estimated to be around £3.9 trillion (see Exhibit 1). This translates into annual assets in motion of about £155 billion currently, including contributions to workplace and personal pensions, and assets moving from pensions into decumulation products. Given the various market changes (e.g., auto-enrolment, pension freedom, shifts in customer preferences), this value is expected to grow to about £180 billion by 2020.



Continued market momentum in accumulation

The defined contribution (DC) pensions space alone represents over £630 billion of assets, £1 billion of profit pool and is a uniquely bright spot in the asset management landscape. UK is the largest DC market in Europe, and is forecasted to grow by 10 percent CAGR in the next five years. By comparison, the current growth forecast for DC assets in the US hovers between 4 and 5 percent¹. One major growth driver in the UK is demographics: the share of core accumulators (50 to 64 year-olds) is likely to continue to grow until about 2020. On top of this, auto-enrolment is expected to add another £8 billion to £12 billion to the current £78 billion in annual workplace pension contributions by 2018—an increase of about 10 to 15 percent². Finally, an additional uplift in net flows can be expected over time from transfers from defined benefits (DB) to DC. Indeed, while currently only DC policyholders can take advantage of the new pension freedoms, the government is considering opening this up to DB holders.

Outside DC, the ISA segment represents over £57 billion in annual contributions a year and is fairly stable, with some step increases in growth driven primarily by changes in individual allowances.

Assets in motion in decumulation: To annuitise or not to annuitise?

In April 2015, about 4.2 million British savers over the age of 55 were given more freedom than ever before to access their retirement pots. It is still unclear how this newfound freedom will impact customers' preferred mix of in-retirement products and how much leakage it will generate from the retirement system (i.e., people cashing out). Forecasts on the expected share of drawdown solutions reflect this general uncertainty, ranging from 25 to 90 percent. Customer research conducted shortly after the UK Chancellor's 2014 Budget announcements on pensions indicated that only one in three UK individuals between the age of 50 and 75 intended to buy a traditional annuity given the new flexibility, and then only for a portion of their assets³. If this shift bears out, with customers moving to drawdown solutions for their discretionary assets and relying on annuities only for basic retirement expenses, the share of in-retirement assets captured by annuities could decline from the current 75 percent to about 30 to 40 percent.

Beyond the pure annuity-vs.-drawdown substitution, there is likely to be a shift towards more gradual retirement process, along with increasing interest in a broader set of savings vehicles. Instead of a 'retirement cliff' at the age of 65, individuals may prefer partial retirement options ('early retirement part-time work'), in addition to generally pushing out their retirement age (see Exhibit 2). Of note, the UK government outlawed age discrimination in 2014, with the result that companies can no longer impose a compulsory retirement age unless they have valid reasons to do so⁴. In fact, the work activity rate of UK individuals over 65 has doubled in the past 15 years and is expected to continue growing⁵. Furthermore, as customer considerations around retirement income shift away from short-timed decisions (e.g., buy 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-

1 McKinsey North American Retirement Practice

2 Automatic enrolment opt out rates: Findings from qualitative research with employers staging in 2014, Department for Works & Pensions, November 2014

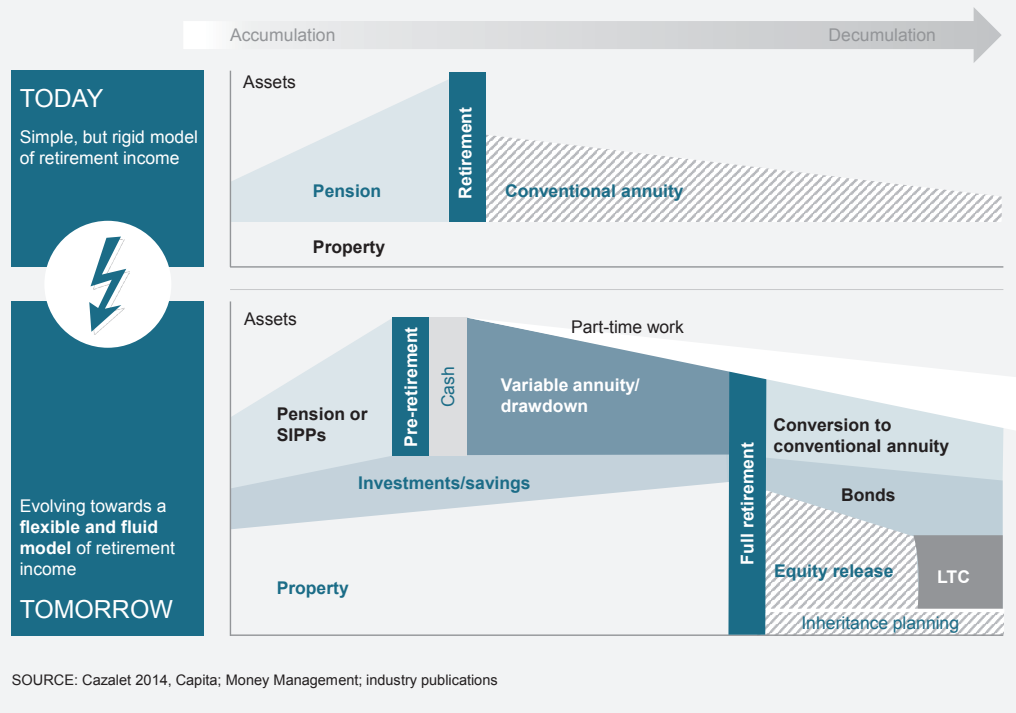
3 The Future of Retirement, PWC, 2014

4 Phasing out of Default Retirement Age, updated 12 November 2014 (www.gov.uk)

5 Office for National Statistics, November 2013

Exhibit 2

Product composition expected to significantly shift over time



term care, home equity release and fixed-income solutions. After similar customer behaviour shifts in the US, the decision to roll over from a 401k pension plan to an Individual Retirement Account has become an anchor event around which advisers sell other financial products.

Why is it difficult for providers to 'win' in retirement?

The opportunities described above may be clear to market players, but capturing them is far from simple. Significant regulatory uncertainties remain, accentuated by political cycles. In addition, dynamics in both distribution and evolving customer preferences will make crafting an effective growth strategy a challenge for asset managers and life insurers.

Structural shifts in distribution

The retirement market is heavily intermediated. Asset managers, pension providers, third-party administrators, platforms, brokers, employee benefits consultants (EBCs) and financial advisers all play different and at times overlapping roles to provide retirement solutions to the approximately 10 million UK adults that own a pension plan or savings account today⁶.

This complex distribution environment is the focus of several current trends. Platforms are taking a prominent role as intermediaries, often steering customer decisions. Direct-to-customer models are well developed and expanding, with intense experimentation and pilots from most players in the space. Finally, bundled DC models appear to be maintaining their popularity, without the push towards unbundling seen in the US.

⁶ ONS, Annual Survey of Hours and Earnings, November 2014

The expansion and evolution of DC platforms: Given the limited differentiation between intermediary platforms, and the pressure to protect economics once rebates are abolished, platform providers are likely to consider either consolidating assets to increase scale or modernising their platforms. This should help in creating seamless, end-to-end experiences that guide self-directed customers, or broader offerings that embed some forms of advice. In general, there is consensus among the players in the industry that platforms will become critical influencers that drive planning and investment choices.

The rise of direct-to-consumer distribution models: The UK is one of the most developed markets in terms of digital distribution. Multichannel behaviour is already widespread in banking, although digital self-service is not yet the norm as it is in the Nordic countries. At the current development rate, the UK market is expected to reach „digital maturity” in the next three to five years. For example, the share of direct distribution in life insurance is about 10 percent today (albeit driven in a large part by protection products), and is forecasted to reach 15 to 20 percent by 2020. Similarly, the share of retail investment funds sold through direct-to-customer platforms has been growing at about 10 percent over the past years, a trend that is expected to accelerate.

Digital direct-to-consumer models can disrupt the market in many ways, and newcomers have the advantage of being unencumbered by channel conflict and legacy operations or IT costs. Examples of disruption include not only digital advice but also new intermediaries across insurance and retirement.

The growth of the bundled DC model: In the US, the unbundled DC Investment Only (DCIO) business captures around half of DC assets, and is the fastest-growing market as sponsors embrace open architecture. In the UK, six out of the 14 major DC pensions platforms offer both a bundled and an unbundled solution. Indeed, the industry view is that unlike in the US, bundled platforms will increase in importance in the UK. But there are likely to be differences between large and small schemes, with large schemes more likely to favour DCIO-type solutions. As the US market structure is more strongly skewed towards large schemes than the UK, the two markets will continue to differ with respect to bundling options.

Changing customer preferences

Customer preferences are also evolving, partly in reaction to these shifts in distribution. Our customer research⁷ highlighted that despite the public debate on pension, awareness around retirement solutions is generally low. There is eagerness to get guidance, but limited appetite to pay for it. Instead, customers look to their employer as their primary source of retirement information, leading to new opportunities in workplace distribution.

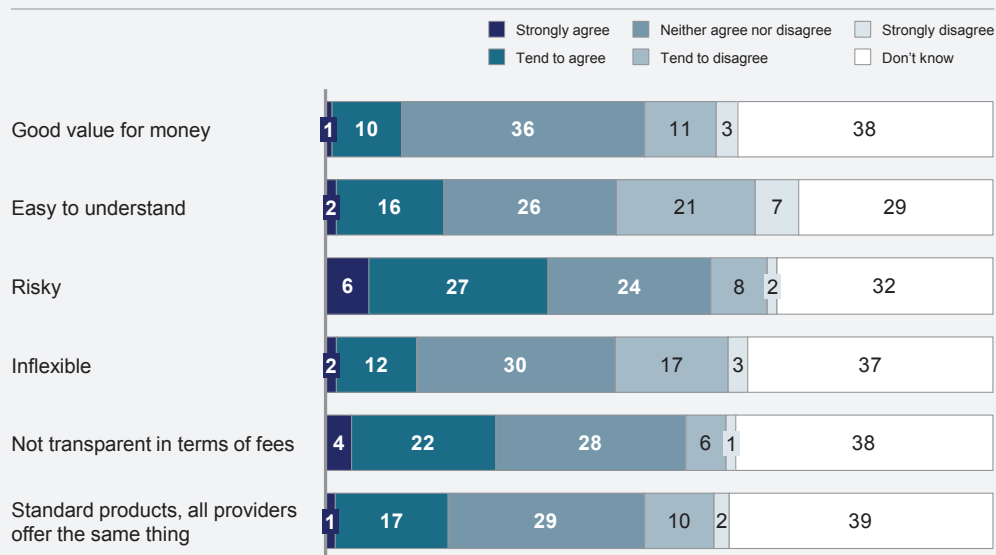
Savings rates rebounded, but awareness remains low. In 2014, the monthly retirement savings rate of British consumers finally returned to (and slightly surpassed) pre-crisis levels. Despite this positive trend, about one in two people still do not save adequately for retirement, and providers are struggling to educate customers and stimulate higher savings. Despite the public pension debate, customer awareness around retirement is low. Only 50% of individuals above 50 years are aware of the changes affecting annitization. Product understanding is also generally limited; about 30 to 40 percent of British customers do not understand the value proposition of drawdown products (see Exhibit 3).

Exhibit 3

Poor customer understanding of decumulation products

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

Percent of respondents



SOURCE: McKinsey-YouGov Customer Survey, March 2015, N = 2,300

Rising expectations towards employers: About 20 percent of people turn to their employer first for retirement advice (see Exhibit 4), despite most of them having a poor understanding of their workplace pension. Over time, customer expectations towards employers are likely to increase both in terms of the quality of the pension plan and the quality of the advice provided. 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, although they are not yet as critical as health benefits.

These shifts point to the potential of workplace distribution. Translating the institutional relationship to up- and cross-selling individual financial products to employees has, however, proven notoriously difficult in both the UK and other major DC markets.

The retirement advice conundrum: With the impact of the Retail Distribution Review still unfolding, middle-class customers still have significant unmet advice needs. In fact, pensions and equity ISAs are the two financial product categories where people want most advice. However, over 40 percent of customers are not willing to pay for advice⁸, and are also not yet fully comfortable with self-service solutions like the emerging robo-advisors⁹. Addressing the middle-market advice gap with productised advice or digital service models will be a tough challenge for retail providers.

7 McKinsey - YouGov Retirement Customer Research, March 2015

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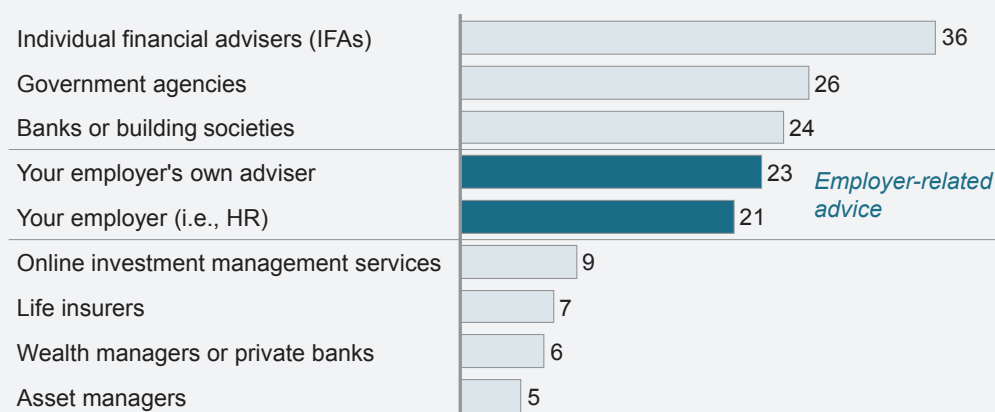
9 Scottish Widows, Workplace Pensions Report, 2014

Exhibit 4

IFAs and employers as critical advice source

Which of the following provider types do you think can best help you prepare financially for retirement through providing advice and/or relevant products?

Percent of respondents



Note: Respondents could select up to 3 options

SOURCE: McKinsey-YouGov Customer Survey, March 2015, N = 2,300

Six strategic levers for asset managers and life insurers

In the face of these various uncertainties and roadblocks, many players have adopted cautious trial-and-error approaches. Strategic exploration and targeted pilots are common (e.g., selective investments in digital distribution and various financial-tech startups). International players – including some global heavyweights – are talking about entering or re-entering the UK market.

Considering the current market context and the trends outlined above, we see six opportunities for asset managers and insurers across the dimensions of distribution, value proposition and operations. The window for capturing these opportunities is limited, and actions that providers take in the next six to twelve months will likely set their course for years to come.

Distribution

1. Build a *direct-to-consumer channel* with an execution-only focus or simple advice. A critical success factor here is traffic generation, including the use of various digital marketing vehicles and online partnerships.
2. Partner with employers and EBCs to build better *digital interfaces* and associated services that help employees manage their DC plans. Such workplace solutions could potentially facilitate the roll-up of the various DC plans held with different providers, as well as the purchase of other individual products and broader employee benefits.

Value propositions

3. Drive growth in the *small/mid-sized DC pensions segment* by setting up master trust structures and creating low-cost, functional self-service solutions.
4. 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 non-annuity products* (e.g., 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 DC plans to Individual Retirement Accounts. Examples of smooth rollover processes include the 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

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



The significant changes taking place in the UK retirement market are creating unprecedented opportunities for insurers and asset managers to transform the market and establish themselves as winners. However, the time window for action is limited – strategic initiatives launched in the next six to twelve months will likely set the course for years to come.

