KPMG

Freeing the future?

Market impacts of the pension freedom reforms

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Research supported by

ABI Association of British Insurers

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Foreword

The Government described the pension freedoms as 'the biggest and most exciting change to our pensions system for a century'[1]. Whilst the reform was merely the latest in a long series of interventions by regulators and Government ministers, it has arguably caused unprecedented impact, certainly if measured in column inches. Pensions on the front pages – this was unfamiliar territory for most people in the industry.

The attention given to the pension freedoms was merited because this reform has huge implications for society, individuals and their families, as well as pension schemes and providers. This has led KPMG, in collaboration with the Association of British Insurers (ABI), to explore the changing pensions environment. We have spoken to over 40 leading individuals in the sector to inform this report, gathering and analysing the views of insurers, asset managers, banks, consumer representatives, advice and guidance providers, think-tanks and the key political architects of the system.

From this research, we are producing two reports on the pension freedoms. This first report describes the background to the reforms, explores perceptions and data about what has happened since April 2015, and then outlines four challenges that apply to consumers, industry and Government. We will follow this with a second report examining the longer-term outlook in this changing pension landscape.

In the run-up to the reforms, there was much speculation and debate about what would ensue. We hope that the diverse and expert viewpoints of those we interviewed for this report will provide some initial answers to that speculation. More importantly, we hope that this report will stimulate and inform a continuing debate – a debate that drives the industry, consumers and policy-makers, collectively, to take the steps necessary to promote the success of the freedoms, and of pensions policy more widely.

Quotes throughout this document have been taken anonymously from our interviews, except where otherwise stated. The companies included in our research are listed on page 24.

[1] http://www.thisismoney.co.uk/money/pensionfree/article-3004305/GEORGE-OSBORNE-s-right-new-pension-freedom-money.html

Pension freedoms – the story so far

The Government's ambition

The Government's stated ambition for pension freedoms was:

Flexibility

Choice

Informed Decision-Making

The challenges

Long-Term Policy

Short-term thinking is creating long-term problems

Customers

The conundrum of how to solve low financial capability, low engagement and low savings

Innovation

Around products and solutions, advice and guidance

Business Strategy

Balancing compliance, legislative and regulatory change with need to gain competitive advantage

Introduction

The UK's pension freedoms were launched into a market that was already complex. Hugely ambitious in themselves, they were part of a convoy of other pensions reforms, including the delivery of automatic enrolment into workplace pensions, and major changes to the State Pension.

The passage of this convoy is transforming the pension landscape, shifting the burden of financial responsibility for retirement across the State, employers and individuals. It would be unhelpful and unrealistic to assess the impact of the pension freedoms in isolation from the wider landscape.

Key changes of the pension reforms:

- Everyone aged over 55 to have flexible access to their DC pension
- Ability to fully encash your pension at your marginal tax rate
- Customer access to free impartial guidance on options at the point of retirement
- Transfers from unfunded public sector DB to DC to be banned

Defining the contours of the pension landscape are the social and economic trends that prompted the reforms: an ageing population, under-saving and historically low interest rates, putting pressure on State and private funding of retirement and prompting a shift from predominantly Defined Benefit (DB) provision to Defined Contribution (DC); and variations in health and life expectancy, family structure and working patterns which are challenging the rigid design of the old system.

In this report our approach is to explore the pension freedoms and their place in the pensions landscape from the perspectives of the three critical stakeholder groups: customers, the industry that serves them, and Government.

For each group, we have established the context before pension freedoms, and then examined the impacts in these early days. Lastly, we have used that analysis to pinpoint the challenges that need to be overcome for the successful delivery of the policy as part of the wider pensions framework.

In a market that is based on long-term planning and behaviours, it is too early to draw firm conclusions about how the reforms will play out in the future, and how the three stakeholder groups will respond to the challenges outlined. However, our analysis provides indications of the path we are on:

- The elevation of pensions to being front-page news is undoubtedly increasing consumer awareness of them. But awareness does not equate to engagement or expertise. Market feedback reinforces concerns about worryingly low levels of financial capability, and low uptake of guidance and advice.
- The need for consumers to save enough to support the retirement to which they aspire is manifest but the freedoms do not fill – or even address – the savings gap.
- The pensions industry went to great lengths to `get over the line' for April, with a focus on enabling access to the new options and deserves credit for doing so in such tight timescales. As a result, limited progress has been made to date on the genuine innovation that will be needed to help consumers successfully take advantage of the freedoms.
- Regulatory demands are huge, and consume a significant amount of finite industry resource.

While our interviews revealed a spectrum of opinion on all subjects, there was uniformity on a key determinant of the future of pensions: with 15 sizeable pensions changes in the past 17 years, there is little optimism that pensions will cast off their current role as political football. Many industry respondents highlighted this uncertainty as a key barrier to consumers having the confidence to save and industry the confidence to invest. Furthermore, the sequence of incremental changes was believed by many to highlight an absence of a clear Government strategy for long-term savings and pensions in the UK. To sustain the football analogy, there appear to be plenty of long balls towards the goal but no overall game plan.

Against that, there is optimism that the pension freedoms will act as a catalyst for the creation of this long-term strategy, as they have already sparked reviews of financial advice and tax relief.

The industry awaits the outcomes of these consultations with interest, but more on that in our second paper to follow.

The pensions world before it was free

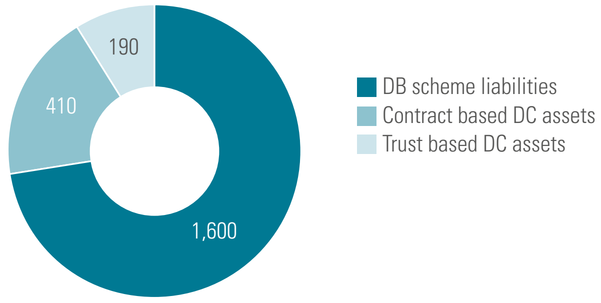
Customers

UK Pensions have traditionally been managed on a paternalistic basis | Customer financial capability and engagement is low | A lack of pension saving is the biggest challenge

It is almost 30 years since Margaret Thatcher's government introduced personal pensions and kick-started the shift towards flexible DC pensions. Yet consumer capability on pensions remains low.

Historically, financial security in retirement has, for most, been someone else's responsibility. In what remains a predominantly DB market, the Government, employers or trustees took the big decisions and consumers got on with their lives, confident that an expert was at the wheel.

Estimated private pension wealth split by DB and DC (£bn)



Source: KPMG analysis, 2014

Efforts by providers, employers, trustees and policymakers to engage and educate consumers to improve financial capability, in particular in the workplace, have had limited success. Industry experience is that a well-conceived programme targeted at the right individuals at the right time can help but this is hard. The statutory bodies set up to tackle this problem, Money Advice Service and The Pensions Advisory Service, have an important role but face ongoing scrutiny of precisely what this should be.

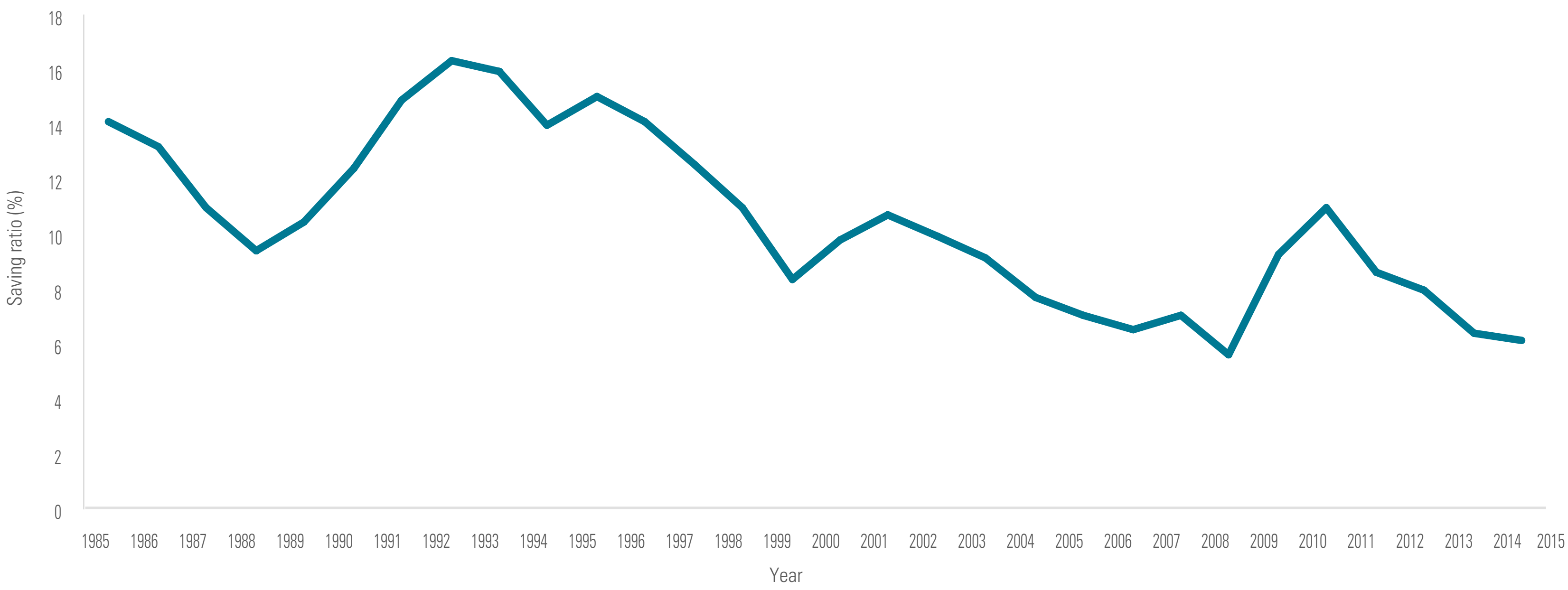
> *"DB was designed for the 1950s nuclear family with a non-working wife and two kids"*

For example, the industry and policymakers have made efforts over the past decade to educate consumers on the value of shopping around for an annuity that would pay them a better rate. Yet, they remain frustrated at the number of customers who do not take advantage of this option.

> *"Decisions about accessing DC pensions are considered the most challenging... major financial decisions from across the life course"*
> *Pensions Policy Institute – 'How complex are the decisions that pension savers need to make at retirement?'*

Few people understand how to turn a pension pot into an income. To do so whilst considering the impact of longevity and investment risk and taking account of personal circumstances to inform decisions on product structure, asset allocation and income level would challenge many a financial professional, let alone the layperson.

UK household saving ratios 1995-2015



Source: Office for National Statistics, July 2015

Most depictions of the pensions landscape in the UK show it looking sunnier since the successful implementation of pensions reform and auto enrolment. Nevertheless, clouds remain with stormy weather predicted just in time for the next generation reaching retirement. When this phase of pensions reform is completed in 2018, around 10 million people of working age may still be excluded from automatic saving, particularly the self-employed and those with multiple jobs below the earnings threshold for automatic enrolment. And, crucially, in spite of the initial success of auto enrolment, the savings ratio has halved, falling to rates last seen in the financial crisis. Britain has rarely saved less.

> *"Our review of customer research suggests that customers are not prepared for the range and complexity of these decisions they need to make at retirement"*
>
> *Financial Conduct Authority – Annuity thematic*

At its heart the industry provides two functions to savers: help for customers to make decisions and management of the money that has been invested.

The Industry

Many Insurers/Asset Managers have spent a generation focused on intermediary distribution more than the end consumer

Legacy of complex products and technology

Traditional industry business models are under pressure

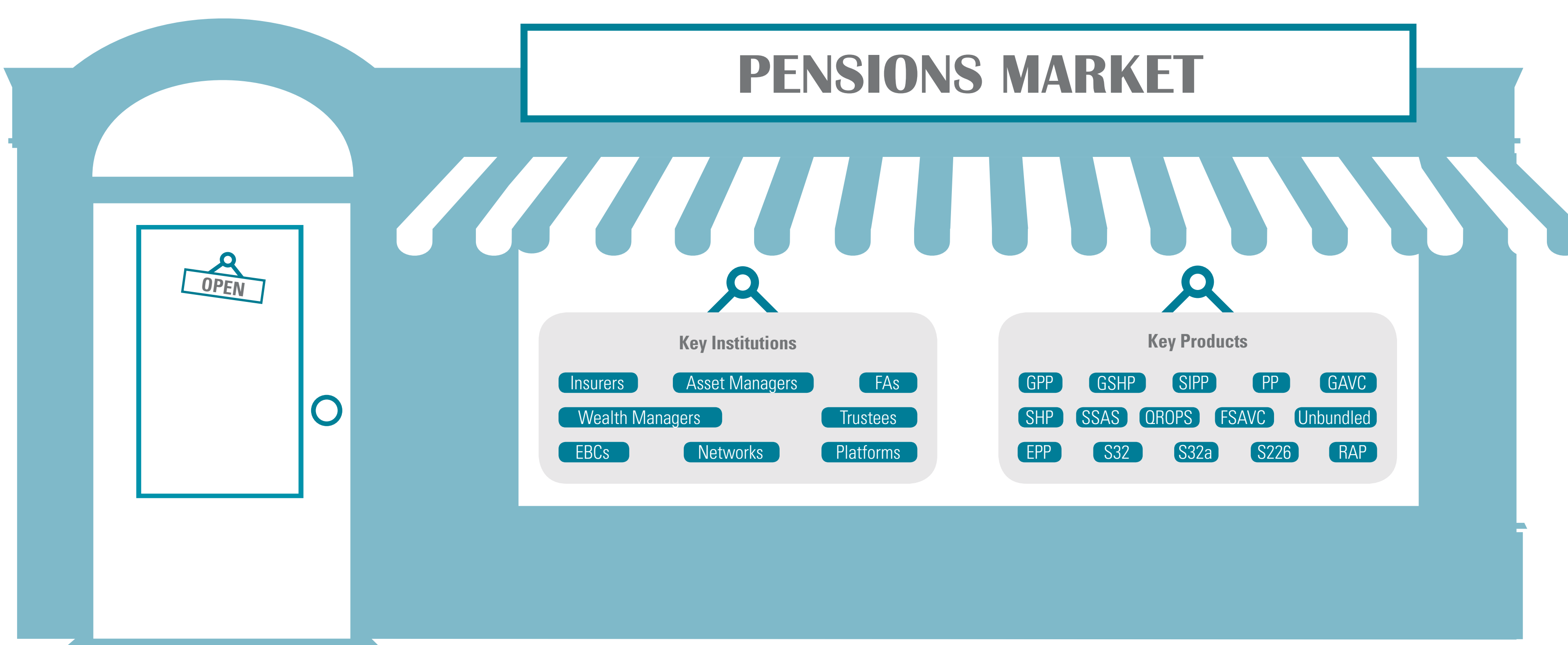
The pensions industry has been built on an intermediated business model focusing more on product design and channel strategies than on the end consumer. Traditionally, most providers regarded Financial Advisers (FAs) and Employee Benefit Consultants (EBCs) as the customer and concentrated on meeting their needs. In turn, EBCs principally focused on employers and trustees.

As a result, it was in the economic interests of providers and intermediaries to design complex products and schemes, in order to demonstrate their value-add. Continual shifts in Government policy and regulation, and the requirement to respond to these with new products, also fuelled the complexity of the pensions market.

> *"Manufacturers have built products around a channel or actuarial view, not the customer"*

Consequently, some larger life companies manage as many as 2,000 product variations, adding significant operational challenge and complexity. As the industry moves towards simplification and better engagement with the end-customer, few life companies are able to travel light.

> *"The constant Governmental focus on price has distorted the focus amongst the insurers causing them to focus on cost reduction and making it harder to invest in building customer centric propositions"*



"The complexity of tax and regulations does not help any provider do the right thing for customers"

Also influencing the direction of pensions firms is the fact that their business models are under pressure from a range of existing factors:

- The Retail Distribution Review (RDR) forced **intermediaries** to transition to a fee-based professional service model. This has led firms to focus on more affluent customers and has accentuated the advice gap.

- The shift from DB to DC and from unbundled to bundled products has led many **EBCs** to begin to focus more on the end-customer's needs and to explore opportunities to generate revenue elsewhere on the value chain (for example, in fund manufacturing, employee engagement/guidance).

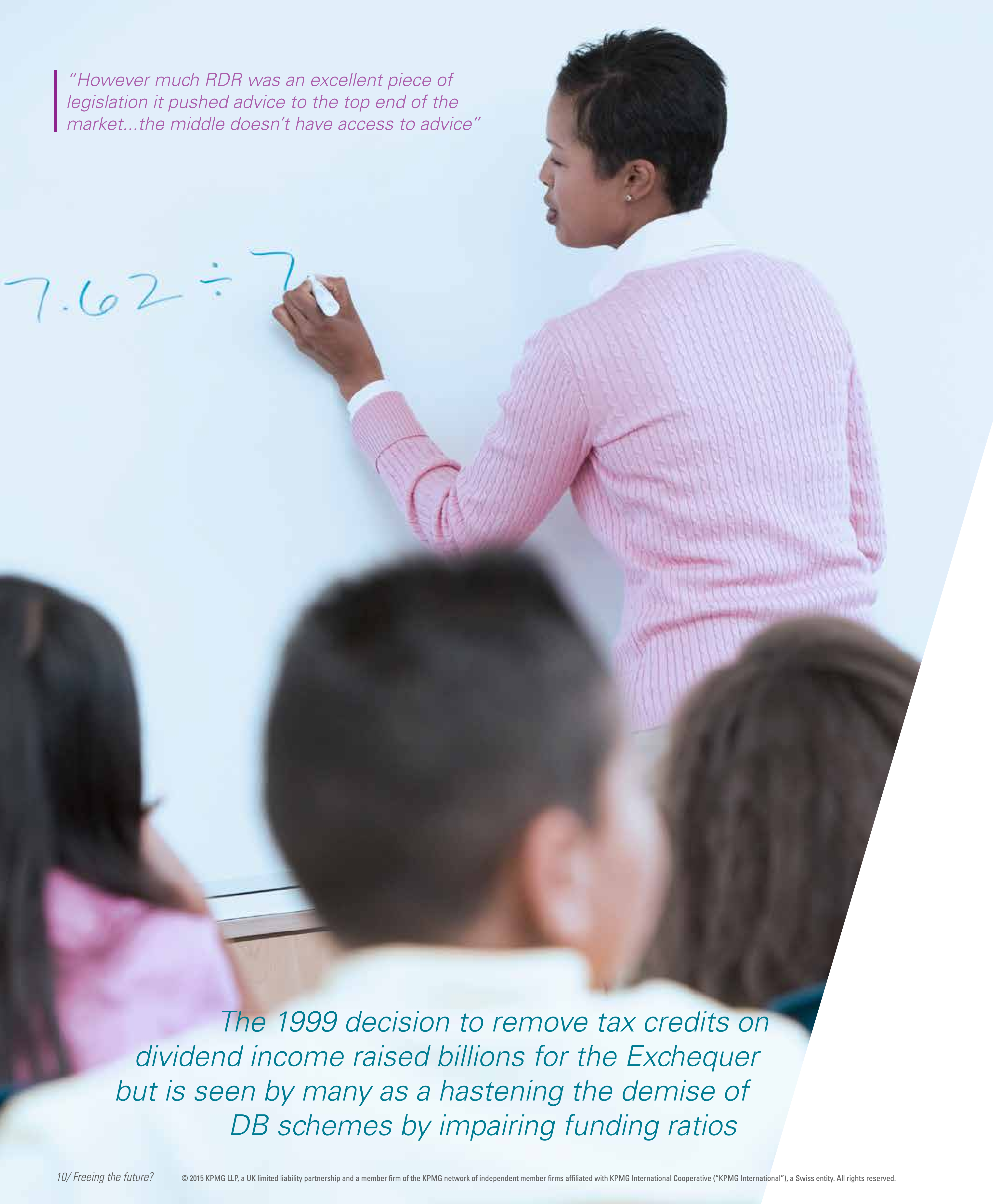
- **Insurers'** traditional intermediated business models have come under pressure as the FA channel has retrenched and multi-channel/multi-product off balance sheet `platforms' have emerged. Combined with regulatory intervention and the decline in insured business and retirement annuity profits, this has depressed earnings and margins. In response, some firms are seeking to gain more influence over customer activity by acquiring advice capability and developing digital strategies.

- **Asset managers** have increasingly moved towards building solutions rather than the components of solutions. Retail firms, having been disintermediated by both direct and adviser platforms, are also developing direct to customer (D2C) capability. In the pensions market, passive investment has become an increasingly dominant component.

All types of firms interviewed for this report expressed concerns that the industry's management culture had – understandably – come to form their business strategies and change agendas around regulation rather than innovation. This opens the door to disruption by firms lacking the burden of legacy products/technology.

"Expanding face to face advice is something which is high on the agenda but has low commercial appeal"

"However much RDR was an excellent piece of legislation it pushed advice to the top end of the market...the middle doesn't have access to advice"



The 1999 decision to remove tax credits on dividend income raised billions for the Exchequer but is seen by many as a hastening the demise of DB schemes by impairing funding ratios

Government

The UK Pensions system has been subject to an incremental revolution

Governmental objectives have not always aligned

Unintended consequences from tactical interventions

There have been 15 significant changes to pensions policy in the past 17 years, comprising both radical policy interventions and complex tinkering.

Most changes were driven by relatively consistent principles: simplicity, flexibility, and increasing the amount people save for retirement. However, policy and regulatory interventions have been driven by different Government departments and regulators, each with discrete policy goals. Given the differing functions of these various arms of Government, it is little surprise that there has at times been a lack of alignment in objectives or outcomes.

> *"Policy constantly changes...Will the changes ever stop?"*

Intervention by diverse departments and regulators, in an area as inherently complex as pensions, has produced unintended consequences:

- The 1999 decision to remove tax credits on dividend income raised billions for the Exchequer but is seen by many as hastening the demise of DB schemes by impairing funding ratios. Their replacement by less generously funded DC schemes has contributed to the widening of the savings gap.

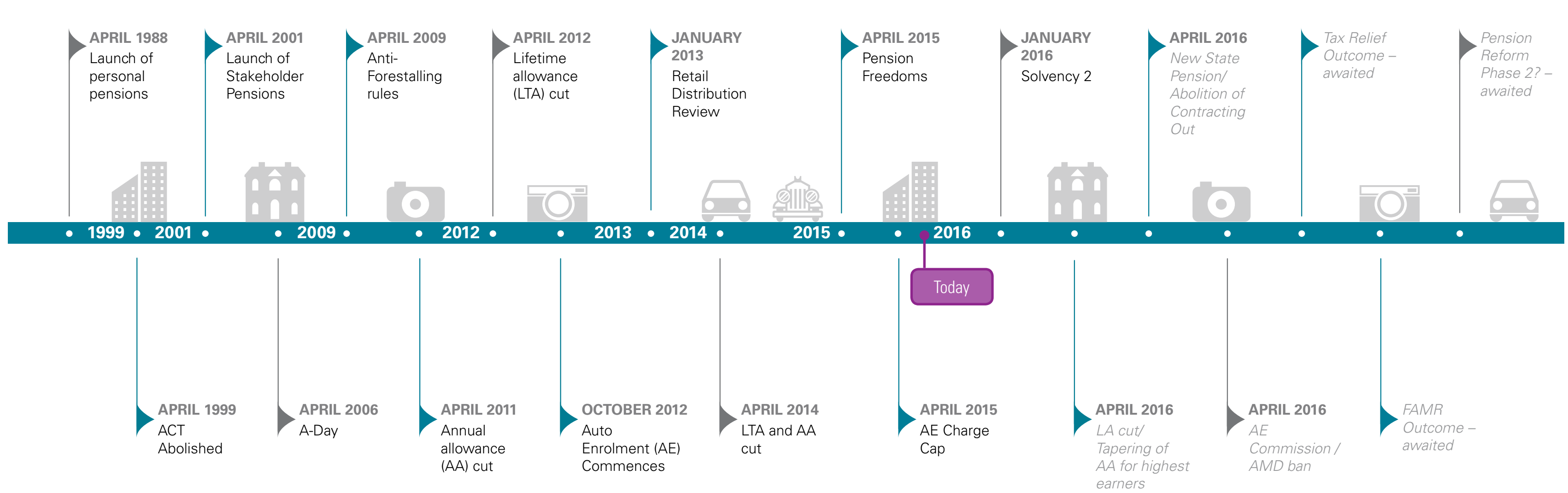
> *"Government are not aligned so instead of making it easier for customers they are making it harder"*

- Pensions Tax Simplification (or A-Day) in 2006 was intended to rationalise the British tax system for pensions but successive annual changes have reintroduced complexity.
- RDR, whilst introducing many important reforms in the retail advisory market has exacerbated the advice gap denying the mass market access to professional financial help and incentivised firms to develop vertically integrated, restricted advice models at the expense of independent advice.
- Auto enrolment has successfully brought many employees into workplace pensions, but there is an abiding concern that it has persuaded many consumers (erroneously) that they are now saving enough for their retirement.

The FSA/FCA embarked on the Annuity Thematic and Retirement Income Market Study expressing concerns around customer outcomes achieved in the retirement market and consumers' low capability to make informed choices. The FCA had yet to fully determine what action to take but it is notable that on the cusp of the launch of the freedoms which would introduce new complexity, measures had to be rushed in through PS 15/04 to establish additional risk factors as a sticking plaster for the lack of underlying customer capability.

> *"Disruptor has been the government...not a new player"*

Ahead of the 2014 Budget, it was recognised by many stakeholders that an approach as radical as the Turner Commission's was needed for retirement, to find a new settlement that balances flexibility and security. The Coalition Government introduced gradual changes to make the legislation on retirement income options less restrictive. However, the announcement of the pension freedoms without consultation was unexpected, as was the speed of implementation.



The early days of the pension freedoms

Given that most people take out pensions with a view to saving for 30, 40, 50 years, it would be rash to attempt definitive conclusions five months after the reforms were implemented.

That being said, one can identify a number of emerging themes across the key stakeholder groups. These trends will help us to frame the challenges to the ultimate success of the pension freedoms.

Customers

The `dash for cash' has been limited | Customer insight limited due to poor data on outcomes | Concerns over financial capability

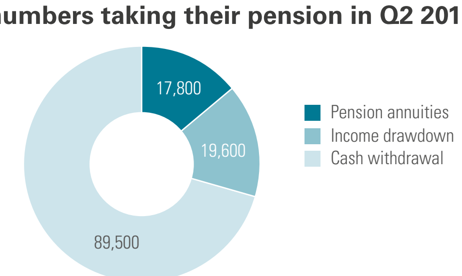
Ahead of April 2015, there was speculation about how customers would behave under the new freedoms, given the gaps in financial capability and engagement, the increased complexity of the new rules, and the low level of trust in mainstream financial services. Concerns ranged from mass withdrawals of cash, to inappropriate product choices, to widespread scamming.

> *"Customers...previously people spent c.20 years thinking their DC pot would buy an annuity. To move away from a 20-year assumption will take time"*

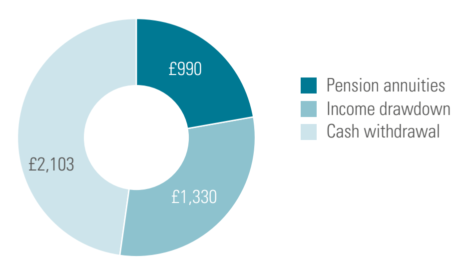
In the event, customers in general have acted cautiously, either delaying decisions or seeking further guidance or advice, or both. As expected, most providers saw a `dash for cash' in the early days of the reforms. As we moved through Quarter 3 2015, there were indications that this initial peak had passed and that customer demand was settling down. However, it is too soon to define the `new normal'.

Industry concern is focused on customers withdrawing their money to leave it in current accounts locking in low returns in an inefficient tax environment as opposed to the media hype around Lamborghinis.

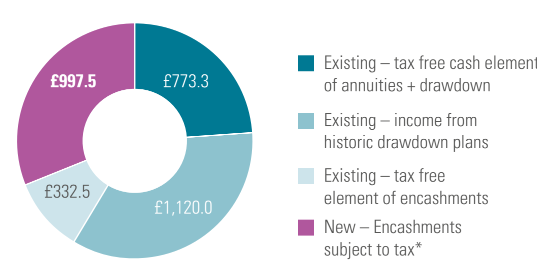
Customer numbers taking their pension in Q2 2015



Value of monies taken from pensions in Q2 2015 (£mil)



Breakdown of cash withdrawal in Q2 2015 (£mil)



This will include a small amount that could have been trivialised under the old rules, meaning that the true impact of pension freedoms is even less

Volume and value of cash withdrawals in Q2 2015

Source: ABI, August 2015

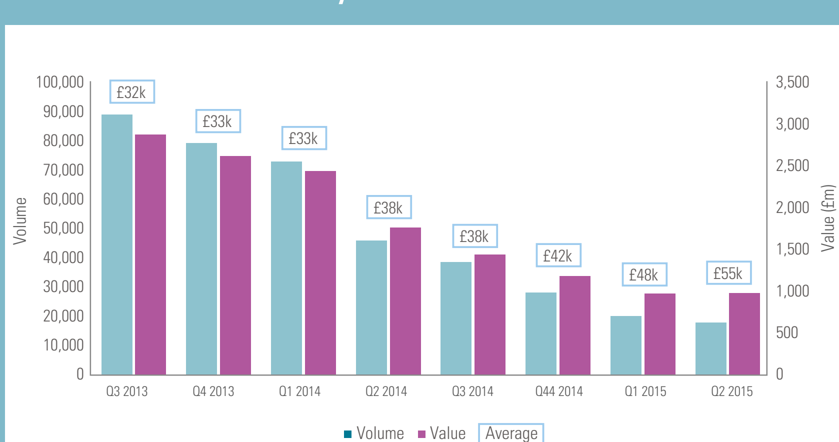
When viewed as a percentage of customers making a decision to take their pension, the 71% who encashed appear to be the dominant majority. However, these have typically been smaller pots and analysis shows that the amount withdrawn specifically as a result of the new rules is actually less than £1 billion representing less than 1% of the value of pension funds held by the over 55s that could have been withdrawn.

Those figures contrast with drawdown withdrawals (including those continuing in drawdown), where over half of taxable payments were for less than £1,000 and over 90% were for less than £10,000. This suggests that, on the whole, drawdown is being used for income and Uncrystallised Fund Pension Lump Sum (UFPLS) is being used for full cash withdrawal. From this it can be inferred that the ability to take chunks of a pension as cash lump sums, whilst made available by much of the industry is yet to be widely utilised by customers contrary to the hype that built up in the press pre-launch about 'pensions as a bank account'. FCA data published in September 2015 confirms that very few customers were using this functionality.

> *"The biggest risk is not Lamborghinis, people are taking all their money as cash then not doing anything at all. Banks are winners"*

As has been widely publicised, annuity volumes have fallen significantly during the last 2 years. An interesting counterpoint is that the average pension pot buying an annuity has increased by 69% to £54,590 suggesting that the annuity market will look quite different in the future.

Volume and value of annuity sales Q3 2013 to Q2 2015



Source: ABI, August 2015

Some firms active in the annuity market reported to us that quote activity has since increased during the course of Quarter 3 2015, suggesting that the future for the annuity product may not be quite as stark as some commentators have predicted.

> *"Our customers are confused, those who are taking money out are not aware of tax implications and restrictions on withdrawals in spite of warnings"*

In spite of the comprehensive retirement risk warnings established by the FCA following calls for a `second line of defence', a number of interviewees raised concerns around the degree to which customers genuinely understood the implications of the decisions they were making. However, many customers also expressed frustration about the need for these warnings.

Some firms active in the annuity market reported to us that quote activity has increased in recent weeks

Fewer customers than expected appear to be taking regulated advice. Against that, a specific source of frustration for some insistent customers has been the requirement to take advice on safeguarded benefits with valuable guarantees. Whilst the feedback from all interviewees was that Pension Wise is achieving what it was designed to do, it is clear that its timing and scope will limit the impact it can have on customer outcomes.

> *"Pension Wise is generally good and we want more customers to go there..they can give customers the broad view..."*

The Industry

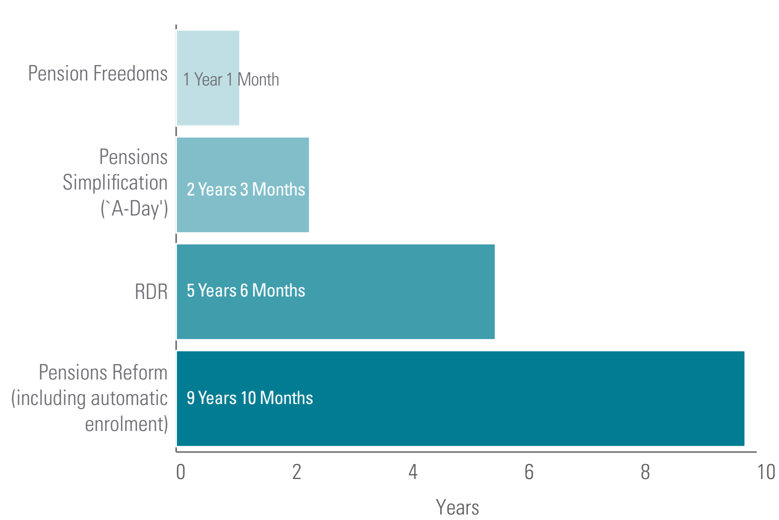
The Industry deserves credit for successfully responding to the freedoms

The freedoms are seen as accentuating the advice & guidance gap

Genuine innovation around the customer & solutions offered has been limited

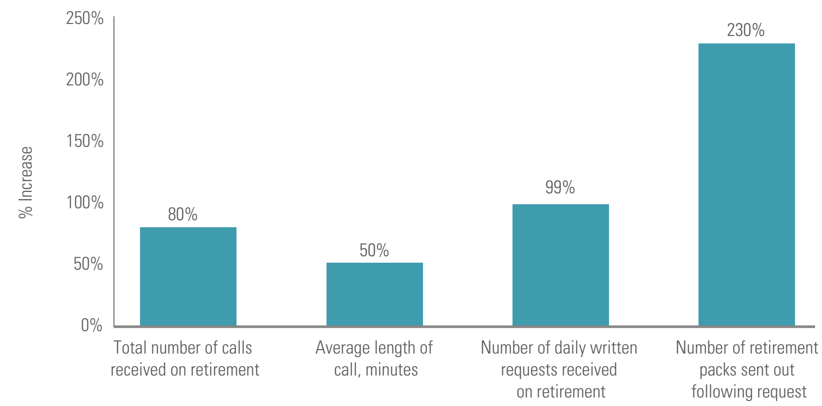
The pension freedoms were implemented significantly faster than all other recent policy interventions, with key details such as the second line of defence framework being confirmed only weeks before launch. Other questions such as the approach to safeguarded benefits remained unclear even when the policy was launched. As such it was unrealistic to expect the implementation of the changes to be perfect on day one.

Key market changes from initial announcement to implementation



> *"The industry responded as well as it could in the timescales provided. Guidance provided by the government was relatively late making it difficult for them to respond"*

% increase in customer service volumes in 5 weeks following pension freedoms



Average figures per week			
	Historic average	Actual	% increase
Total number of calls received on retirement	126,141	227,228	80%
Average length of call* (minutes)	6.2	9.3	50%
Number of daily written requests received on retirement	19,515	38,830	99%
Number of retirement packs sent out following request	12,424	41,055	230%

**Includes range of enquiries. Clients taking their pension typically take significantly longer than the average or require multiple calls*

Source: ABI, July 2015

Given the short timescales and the last minute and fluid nature in some of the rules, pension firms deserve credit for the degree to which they were able to support the changes. Whilst in many cases the solutions delivered were inelegant – involving internal transfers and paper-based processes – most eligible customers were given access to their pension pot from day one. By and large, service levels were maintained, even though the initial weeks subjected the industry to significant spikes in demand.

The customer experience delivered across the industry remains a work in progress, with regulation heavily influencing design.

KPMG has observed telephone interactions in which customers could be prompted as many as 13 times to take guidance from Pension Wise and/or regulated financial advice if they wish to discuss all options. In such cases firms have followed the letter of the FCA rules but this raises the concern that the repetitive nature of the prompt dilutes its importance to the customer or as has been suggested creates a 'boy who cried wolf' syndrome. Our diagram opposite captures the baseline process from one insurer and how it compares to other financial products you can buy.

In this example process, it could take a customer up to 40 minutes to encash their pension. There are clearly significant opportunities for the industry to improve the quality of the customer experience but it is also worthwhile to consider the extent of the consumer protection steps in place to ensure customers know what they are doing before they access their money.

> *"We don't expect to see the new normal until 2016"*

The launch of pension freedoms has exacerbated existing concerns about the advice gap and made policymakers take note. If RDR reduced the supply of affordable advice to the mass market, then pension freedoms have undoubtedly increased the need for it amongst consumers whose financial affairs may not have previously appeared complex enough to warrant regulated advice.

Advice firms recognise the mass market opportunity but although most are confident that economically viable models can be built using digital and omni-channel approaches, they are deterred by the perceived conduct and Financial Ombudsman Service (FOS) risks within current regulation. Some notable pioneers are pushing on regardless, and these examples of new advice models are being watched with interest.

Similarly, some employers have sought ways of providing greater decision support for their workforces at retirement but this is an area that trustees find challenging. EBC interviewees highlighted the nervousness that exists about extending their responsibility for supporting members into decumulation.

> *"There is a great gap between full advice and no advice...this was a failing from the beginning when the pensions freedom policy was announced"*

Radical reforms, such as the pension freedoms, demand an innovative response. In time, we expect to see significant innovation in the nature of decumulation products and customer channels offered, but to date progress has been very limited. Firms have understandably focused on enabling access to new options, updating their IT systems and ensuring their operations teams could cope with the initial peak of demand.

Innovation so far has typically been tactical, focused on extending the availability of flexible drawdown and cash lump sums and building on existing customer engagement and channel strategies. New solutions and channels such as the Aegon Secure Lifetime Income product and LV= Wealth Wizards investment are rare examples of new propositions that have been built into providers' propositions since the freedoms launched.

One priority area of innovation is scheme fund defaults. The freedoms have invalidated much of the traditional thinking around defaults for accumulation and decumulation. This has fed back into EBC and employer debates around whether to go for single or multiple defaults.

> *"The immediate impact is what to do with the 80 to 90% of members who are in default funds...tracking towards annuity purchase"*

An example retirement conversation

5 mins	Call waiting & option selection
1 min	ID and V (identify and verify)
3 mins	Introduction & recommend advice/ Pension Wise
3 mins	Explain high-level retirement options
5-15 mins	Retirement options in detail (if customer wishes to discuss one or more options in detail)
2 mins	Implications for safeguarded benefits
1 min	Explain tax implications
1 min	Confirm customer has understood their options
5 mins	Risk factors and warnings (where customer made a decision in principle)
2 mins	Confirm quote/illustration will be sent out with application form
2 mins	Customer satisfaction

Approx. Total Duration **30-40 mins**

In half that time you could have...

Opened a betting account	2 mins
Made an online payment from your bank account	2 mins
Submitted a credit card application (including personalised design)	3 mins
Applied for a £20,000 car loan with a high street bank	5 mins
Applied for a £400 pay day loan at 400%+ APR	5 mins
Made a cup of tea	2 mins

> *"The central issue is that the government want people to have choice but hadn't really considered whether this should be a good choice or genuine free choice. This has fed into the providers, regulators and other related bodies not really knowing how to implement the reforms"*

Government

The Pension Freedoms were popular with the public and many in the industry

The Government's strategy and vision for long term saving is unclear

Widespread concerns over unintended consequences

When the pension freedoms were announced in March 2014, both industry and consumers broadly supported the Government's aim to improve outcomes in the retirement market although many flagged concerns about customer outcomes in the absence of steps to address financial capability and the advice gap.

Perhaps the most conspicuous and immediate impact of the reform was to make pensions headline news, thereby bringing to public consciousness the need to save for retirement.

> *"We have created regulatory asymmetry where if the customer encashes there is virtually no protection, whereas if they buy an annuity or drawdown, there is"*

However, headlines and consciousness-raising aside, a consistent theme for interviewees was a lack of clarity about the Government's overall strategy for encouraging pensions and long-term savings, and within such a strategy, the role of pension freedoms.

Ultimately the policy will be judged on how consumer outcomes measure up against objectives. Although this is difficult as the Government were deliberately neutral on what those outcomes should be. In the complex field of pensions, it is hard to avoid making changes without generating conflicting and overlapping outcomes:

- The success of automatic enrolment partly depends upon member inertia but freedoms require active engagement by individuals.
- Simplification is a long-standing policy objective but freedoms have heaped more complexity on the customer decision-making process.
- The lack of financial capability was regarded as a key reason for the inefficiency of the annuity market but freedoms make consumer decision-making more difficult.
- Consumer expectations were raised that they could treat their pension like a bank account but in practice many are frustrated at the difficulties around accessing their cash, due to providers' processes or regulatory hoops.
- It is also unclear that having consumers regard their pension as being interchangeable with a bank account is in itself a desirable policy outcome.

Pension freedom has also triggered fundamental questions about policy areas connected to pensions – notably, advice and taxation. Subsequently, the Government has announced reviews in both of these areas, with a stated desire to be radical. It remains to be seen whether these are indications that the Government is pursuing a tactical agenda focused on specific issues, or tackling the holistic issue of long-term savings policy in an aging population.

> *"There is a mismatch at the heart of freedom and choice – customers have not been given the responsibility that freedom implies"*

Many of our interviewees commented on a perceived misalignment between the goals and achievements of regulation: the policy intent is to give individuals more control, yet the decisions they have to make have become more complex. A recurrent theme in market feedback is the need to find a more effective regulatory balance between individual responsibility and consumer protection. How far from the paternalistic model of old should we move, and how do we ensure that consumers are clear on – and able to handle – their responsibilities?

> *"Who is accountable for decisions – the individual or the Financial Services industry? Moral hazard is that if it does go wrong the tax payer has to bail them out"*

After all, if consumers are given freedom to make choices, to what extent should they share responsibility for the consequences of their decisions, both good and bad?

Now we are free, what next?

Like all revolutions, the impacts of the pension freedoms will take time to materialise and some effects will not turn out as the revolutionaries intended. (Or perhaps as the people were led to expect.)

Whilst it is too early to be certain of the final outcomes, our analysis of how the various stakeholders are behaving at the outset indicates the longer-term challenges that must be met if the reforms are to succeed. Indeed one of the key questions that remains unclear is what exactly success means and how will we know when any poor decisions by customers may be unclear for years?

We set out these challenges below.

1. Policy – may we have a strategy, please?

George Osborne has lobbed a grenade into the retirement market and although the dust has not yet settled, it is already clear that pension freedom will generate wider change. It seems that the Government has already come face to face with impediments to its pensions reforms – as evident from its announcement of consultations on pension tax relief and incentives. Having deployed one grenade, the Chancellor is unlikely to stop there.

> *"The risk is mass market will be uninformed, under invest and will have to work longer in a resentful way"*

There is widespread support for optimising the incentives to save for retirement and making advice more accessible to those less able to pay current advice fees. But the overarching challenge to policymakers remains the need to articulate a clear, sustainable and joined-up strategy for UK long-term savings. Preferably one joined up with other areas of welfare and health policy. And of course, one that is underpinned by regulation that is complementary to its objectives and applications.

The Regulator must also be clear on its role. To facilitate a healthy market that can support customers making the complex decisions that will be required at retirement a workable solution must be found around advice boundaries.

As this hoped-for strategy is developed, it will be critical for both Government and industry to consider the needs of the different savings generations, each of whom have demonstrably different challenges and behaviours. It is clear that the historic `one size fits all' approach has not worked and is creating generational inequalities.

2. Customers – how to win friends and influence people

The issue of low capability, engagement and inadequate savings existed before the freedoms and the changes have done little if anything to improve the situation. Judging from international experience, this cannot be remedied quickly or simply. This remains the challenge for consumers and all evidence is that it will take at least a generation to solve.

On the one hand, pension freedoms are a step on the long journey towards improving financial capability: but engagement cannot be achieved purely by forcing consumers to make decisions.

> *"Middle income earners in the next generation will face a massive challenge as peak DB will have passed to be replaced by less generous DC, and property ownership will be lower... They will be the first generation to be worse off in retirement"*

On the other hand, the reform very publicly compels pension firms to develop ways of dealing more effectively with the end-customer (as opposed to intermediaries, trustees and companies).

Pension freedoms have highlighted the industry's ability to implement regulatory-driven change, meeting customers' transactional and regulatory needs largely without adverse administrative incident. However, there is a gulf between complying with rules and the transformation needed to move to a more customer-centric model.

The challenge for a pensions industry historically focused on manufacturing and wholesaling products is to push further to develop a customer service orientation not previously part of its DNA. This will require significant cultural change for firms bold enough to test whether their people, processes and technology are fit for purpose.

3. Innovation – growing green shoots into established roots

When the rules of the game change, there is no option but to innovate. The freedoms require strategic innovation in two main areas, one being in the industry's comfort zone, the other outside it.

- **Products and solutions**: there is considerable thinking around new product designs, and especially new defaults for both accumulation and decumulation but as yet limited output. Whilst the pensions industry revels in new product development, its challenge is to move from products suitable for groups of employees aiming for a fixed retirement date, towards solutions appropriate for small segments or individuals with particular needs for whom retirement will be a phase not an event, and from products that are distributed via intermediaries to those that can increasingly be sold directly.

  This challenge is magnified by the fact that retirees options have become more complex, calling into question the viability of defaults for decumulation at a time when the advice gap for the mass market remains.

- **Advice and guidance**: the freedoms did not create the advice gap but have made it worse, pushing it up policymakers' agendas as evidenced by the launch of the Financial Advice Market Review (FAMR).

> *"One of the most significant features of the new policy landscape is that it is effectively a self-selection model, which means it is underpinned by an equation of responsibility that, frankly, we've never seen before. Political responsibility certainly, as well as industry and policy making. But also, crucially, consumer responsibility"*
>
> *Martin Wheatley, FCA NAPF Conference, March 2015*

"Fewer customers buying an annuity may make the risk pool smaller... therefore they become a worse deal for those that remain"

The stand-off between the industry and regulator around mass market advice/guidance provision must be solved. The solutions are likely to be a mix of phone and digital. Automating advice and guidance processes using digital technology, as seen in the 'robo advice' sector that has emerged in the US, is not a new idea but has divided the industry into two camps about the practicalities.

1. The larger camp is put off by the potential conduct and FOS risks arising from perceived regulatory ambiguity about the boundaries between advice and non-advice.

2. The smaller camp has been prepared to take that risk and, although it includes a small number of incumbent pensions firms, largely comprises new entrants.

The challenge is how to develop effective automated advice and guidance propositions that meet both consumer and regulatory requirements.

> *"Even though annuity has become a dirty word, it's not clear that customers are looking for something different"*

4. Business strategy – fight or flight?

The pensions market is approaching a tipping point. Whatever the outcomes of multiple pensions reforms, changes to tax relief, a new advice regime, new FCA leadership and various EU directives compounding the ever-present challenges of competing in the market, tomorrow's pension environment will be materially different. The challenge to the industry is two-fold:

- How to balance the demands of compliance with legislative and regulatory change – essentially how to stay in business – with the need to develop long-term strategy to deliver competitive advantage.

- How to build long-term strategy in a sector driven by policymakers who may themselves lack a clear, sustainable strategy for UK long-term savings.

> *"The providers should stop asking what products we can create, and start asking what do customers need? This is a difficult task, as core mass market customers don't know and/or can't express a need"*

> *"Retirement is a series of straightforward choices, it's the industry that makes it complex. Digital market will inevitably grow"*

Firms are approaching the point at which they must decide whether the rewards of remaining in the pensions market outweigh the risks, or whether they should deploy capital elsewhere. This involves sizeable investment decisions, even for market leaders, and with so many variables capable of influencing future market dynamics, it is imperative that firms identify the key variables and model the potential effects in scenario planning. And whatever strategies emerge, flexibility will be critical: the pensions industry will remain the focus of Government lab tests for a while yet.

> *"Robo-Advice is the only way to solve the cost issues in filling the advice gap"*

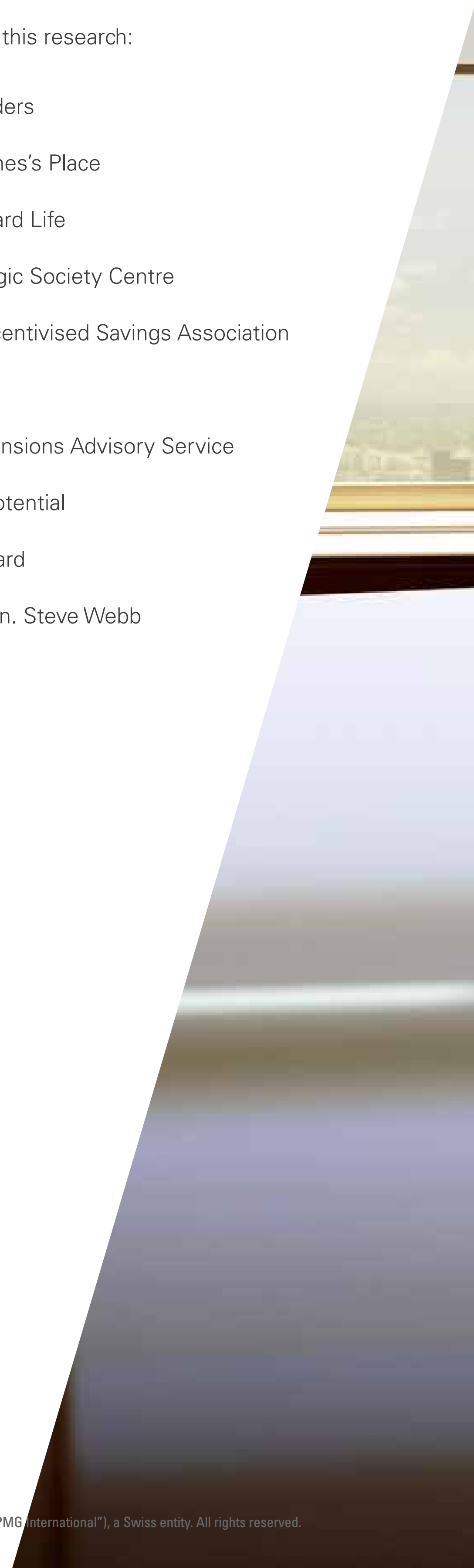
But it's important that firms don't see themselves as the fatalistic \`victims' of such activity. These are exciting times for firms that choose to be bold and consider these challenges as opportunities. We think the freedoms may prove to be the pensions industry's own \`RDR' in that they will accelerate healthy changes already underway and transform the supply chain in ways that lead to more positive customer outcomes…eventually.

How this all unfolds will be the subject of our second report.

Acknowledgements

KPMG would like to thank the Association of British Insurers and the following firms/individuals for their involvement with this research:

- Aberdeen Asset Management
- Aegon
- Aviva
- Charles Stanley
- Citizens Advice
- Fidelity
- FNZ
- Foster Denovo
- Hargreaves Lansdown
- HSBC
- JP Morgan
- Just Retirement
- KPMG Pensions
- Lighthouse
- LV=
- Mercer
- MetLife
- National Association of Pension Funds
- National Employment Savings Trust
- Nutmeg
- Old Mutual
- Pensions Policy Institute
- Phoenix
- Prudential
- Royal Bank of Scotland
- Royal London
- Schroders
- St James's Place
- Standard Life
- Strategic Society Centre
- Tax Incentivised Savings Association
- Towry
- The Pensions Advisory Service
- True Potential
- Vanguard
- Rt. Hon. Steve Webb
- Zurich



Contacts

Phil Smart
UK Head of Insurance and Investment Management
E: phil.smart@kpmg.co.uk

Andy Masters
Partner, Savings and Wealth
E: andy.masters@kpmg.co.uk

www.kpmg.com/uk/savinggenerations

CREATE | CRT046369A | September 2015 | Printed on recycled material.