Paradise postponed

Long-term impacts of the pension freedoms

Research supported by

ABI Association of British Insurers

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Contents

Foreword

"George Osborne has lobbed a grenade into the retirement market and although the dust has not yet settled, it is already clear that pension freedoms will generate wider change"

Pensions paradise postponed – meeting the four challenges

Our first report, Freeing the Future? focused on the initial impacts of the new pension freedoms (PF) on the UK pensions and retirement market. In doing so we identified four key challenges that need to be confronted by policymakers, regulators and industry if the reform is to succeed in the long-term.

1. Policy – may we have a strategy, please?
2. Customers – how to improve capability and engagement?
3. Innovation – will industry grasp the nettle?
4. Business strategy – fight or flight?

Scope

This second report explores the longer-term impacts of the freedoms in the context of these four themes. We will concentrate on areas where the reform has had most effect, namely during the at-retirement and decumulation phase.

Already, PF have proved a catalyst for other important potential reforms, such as pensions taxation and guidance and advice. However, in this report we will only consider other adjacent areas insofar as they could directly affect the outcome of PF.

Timeframe

What do we mean by 'long-term'? Nothing in the world of pensions happens quickly, witness some of the PF ideas first put forward under the Peter Lilley proposals in 1997 and auto enrolment (AE) seeing the light of day nearly a decade after the Turner Commission published its first report in 2004.

But in this report we use 'long-term' to mean longer than a single administration or normal business planning cycle, ie five years or more.

Methodology

In partnership with the Association of British Insurers (ABI), KPMG research has included interviews with over 40 leading individuals in the sector, 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. This research has been used in both reports on the freedoms, supporting analysis of the short-term and now the long-term impacts of PF.

Quotes throughout this paper have been taken from our interviews except where otherwise stated. Firms or individuals who took part in our research have been listed on page 40.

The long-term picture

Policy

- Success of PF depends on success of AE
- AE needs to become more prescriptive
- Accumulation incentives should be more effective to attract higher savings

Customer

- Consumer education will take a long time to alter behaviour
- Focus should be on increasing engagement
- More accessible guidance and advice is key to increasing engagement

Innovation

- Innovation will intensify around the customer experience
- 'Robo' in robo-advice will quickly be consigned to history
- Market efficiency will be boosted by greater investment in infrastructure

Business Strategy

- Convergence between wholesale and retail pensions will challenge business models
- Operating environments will become more complex as firms strive for customer centricity and vertical integration
- Some innovation and change will have a 'back to the future' flavour – 'the bionic man from the Pru'

Executive summary

"Surely the freedoms are somewhat redundant - if you've not saved enough in the first place, flexibility isn't so useful..."

Policy

- So long as the world remains politically and economically volatile we should not expect greater stability from policymakers or more joined-up long-term thinking to take precedence over shorter-term expediency.

  Does this therefore mean that PF are condemned to flounder in the UK?

- Ultimately, the success of PF is dependent upon the success of AE. This is one piece of long-term policy where momentum must be sustained if retirees are to have sufficient money at retirement to benefit from freedom and choice. For this to happen, AE must become more prescriptive and the tax-based incentive more effective.

Customer

- Most consumers are neither sufficiently capable nor engaged to assume responsibility for making PF decisions. Government, regulators, employers and industry should focus on building foundations to improve capability and using PF momentum to boost engagement.

- Raising capability will take a generation and there is little international precedent for successful educational programmes. Practitioners believe targeted communications work better than holistic education.

- Raising consumer engagement will be driven by AE and guidance and advice. AE will raise engagement but only in the long run as both contributions and account values become more significant.

- A new guidance regime must be affordable and engaging but also commercially attractive. The advice gap is not just a supply-side issue: consumers are culturally unused to seeking investment advice. To understand the demand-side more deeply, new guidance propositions should first be sandbox-tested in the at-retirement segment.

Innovation

- Innovation in customer experience around guidance and advice will prove more influential than product innovation but there remains a healthy future for re-branded, better value, better targeted annuities.

- Other product innovation will involve the emergence of universal accounts which help customers manage multiple sources of income and asset classes, including cash, ISAs, equity release and rental income.

- In terms of guidance and advice, PF will trigger profound innovation in advice services both in the nature of delivery and the surrounding customer experience.

- Robo-advice will soon lose the 'robo' label as digital delivery expands beyond transactional to planning and monitoring. Digital will be equally as important for automating advice and investment processes as an engagement tool to attract customers and understand their needs.

- The threat of disruption is greatest at the customer interface rather than product, asset management or administration. Indeed customers will eventually become their own gatekeepers.

- The industry will also need to invest in common standards and infrastructure if it is to achieve a step-change in costs and efficiency.

Business strategy

- By providing a customer experience that appears personalised but is cost-effective to supply via multiple channels and media, the winning firms in the new era will be those that transition from asset gatherer to customer gatherer.

- In the face of margin pressure, vertical integration will give advantage to firms competitive in more than one role. However, there will remain room in the market for specialist boutiques, and for a few large low-cost operators able to generate scale economies.

- Facing up to hard decisions will call for strategic honesty from incumbents whose flexibility and resilience will be tested by potential disruptors: choosing to specialise or not to participate may be the optimal decision for some. Concurrently, some familiar models and propositions from years gone by will reappear but in different guises such as the 'bionic man from the Pru'.

- Ultimately, the successful 'case study' firms of the new era will be those that can demonstrate strategic agility and customer centricity.

Policy - joining up the dots

Since pensions involve the very long term, it is understandable that the industry and its customers yearn for a clear UK strategy from Government. It is logical to seek a strategy that joins up with related areas such as welfare, tax and long-term care. Above all, it is rational to ask for stability of policy.

However so long as the world remains politically and economically volatile, it is unlikely politicians will change their spots. We should not expect greater stability or more joined-up long-term thinking to take precedence over shorter-term expediency.

This chapter examines the pensions policy environment in the UK and whether a lack of policy stability or long-term strategy will condemn PF to flounder in the long run.

We think not, but ultimately the success of PF depends, above all, on one key factor: accumulation.

As this chapter explores, if AE works, so can PF. But if retirees are to have sufficient money at retirement to benefit from freedom and choice, AE must become more prescriptive and the tax-based incentive more effective.

After 15 significant changes to pensions policy in 17 years, it is not surprising that two themes arise consistently in discussions of pensions in the UK.

The first theme is the need for policymakers to articulate a clear strategy for UK long-term savings. Ideally, this strategy would fit with adjacent fields such as welfare, long-term care and tax. It would also be free from the continuous tinkering that has plagued pensions policy in recent years. It is not necessarily the case that the market considers the reforms ill-judged – in fact, largely the opposite is the case regarding AE and PF. However, there is a desire to know how each reform fits within an overall strategy and to see 'where this is all leading'. This would enable firms to plan their own change programmes in less of a reactive – and thus costly – manner and give customers greater certainty for retirement planning.

"The big picture debate is not happening – how far and fast does the State want to retreat from welfare provision and pass to individuals? It's being done piecemeal"

For the purposes of this paper, we have assumed a core policy goal of increasing savings for retirement and optimising decumulation decision-making, thereby improving personal financial wellbeing and lightening the burden on the State. We recognise that shorter-term issues, such as austerity and re-election, may take priority; nevertheless, the forecast decline in the figures for the UK's replacement ratio underline the need for a long-term strategy.

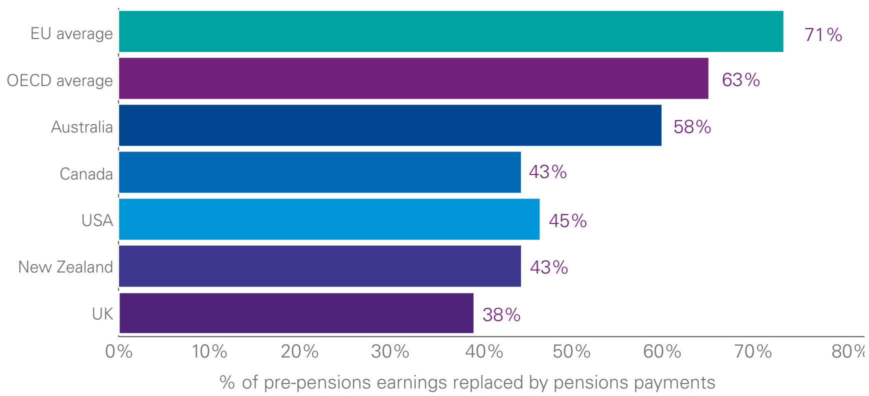
The UK is one of the few OECD countries without a compulsory second tier that includes corporate benefits. The UK's current replacement ratio of 38.3% is expected to drop to about 20% over the next 15-20 years[1] owing to the lack of a viable replacement for the defined benefits (DB) pensions regime.

The second theme that emerged in our research was stability. The cry of 'simplification' has resounded in the pensions market for many years: the net result has been further layers of complexity across multiple systems. This disengages consumers, increases the need for professional advice and inflates costs in the supply chain. Surely policymakers can

UK needs a clear strategy for long-term savings that joins up with related areas of policy

Net replacement rate 2014

Defined as the individual net pension entitlement divided by net pre-retirement earnings, taking into account personal income taxes and social security contributions paid by workers and pensioners.



Source: Pensions at a Glance, OECD, December 2015

[1] Pensions at a Glance, OECD, December 2015

There will be no stability without strategy

agree, once taxation and advice regimes are attended to, that the heavy lifting has been done by AE and PF? Continued instability will put at risk the undoubted potential benefits of these reforms.

"Political tinkering has been like incremental food additives…the problem is there is no single owner of the whole agenda when a joined-up strategy is the logical objective"

"Stability is unlikely for several reasons. So many changes made so quickly mean lots of snagging fixes needed. PF stole the headlines but much is still to do on AE. The big one is how customers will react over time, we can't know the new normal for some time"

The Pensions Minister's postponement of defined ambition and 'pot follows member' suggests an acceptance that the overriding objective must be to allow the major reforms to bed down. Yet, politicians generally believe they are elected to make things better, a view they habitually translate into changing policy. The key question, therefore, is for how long can policymakers refrain from further changes. The issue here is not just stability: history suggests that pensions reforms produce unintended consequences.

We cannot expect stability without strategy: if there is no clearly articulated strategy for UK long-term savings, no transparent objectives to be delivered by specific policies, how will policymakers know when the job is done?

Understandably, there is a certain scepticism in the market, an assumption that politicians will not change their spots, and that whilst economic conditions remain fragile, fiscal demands will drive pensions policy. Yet there is an undercurrent of cautious optimism, a belief that most of the components of a strategy are already present, typified by the wry observation in our research "but there is clear pensions long-term strategy…apart from the politics of course".

The achievements of recent past reform have been founded upon a consensus across not just political parties but many key stakeholders including consumer groups and industry. For example:

- the consensus leading to simplification and AE was built around the Pickering and Turner reports
- the more recent reforms received broad cross-party support

The UK Government and the Financial Conduct Authority (FCA) have also worked with industry on how best to implement and regulate PF. The challenge is how to sustain this.

Unintended consequences

Policy area	Unintended consequence
Stakeholder pensions	Stakeholder plans' fixed price can be twice that of modern products
A-Day	A-Day simplified previous complexities but added new ones
Personal pensions	The introduction of personal pensions led to many leaving SERPS and DB schemes and becoming worse off
Retirement age	Removing contractual retirement age has resulted in an HR version of 'bed-blocking'

Source: KPMG illustration purposes only

One option is the concept of a standing Pensions Commission which can influence policy independently, along the lines of the independent Bank of England or New Zealand's autonomous crown entities. However, we found little support for this in our research.

"Pensions are too important not to be controlled by elected representatives"

"Nice idea but there is so much money at stake for HMT, would they listen?"

The lack of support stems from a sense that, whether or not a Pensions Commission is a good idea, it is unrealistic to expect the time and resources required to set one up. There remains, however, a belief that ministers should have ongoing support from a group of pensions and retirement specialists representing all key stakeholders. An independent policy body need not be labelled a Commission nor have a high profile. Rather, the group would have licence to give politicians directional and practical advice and, if need be, challenge proposed policy against the overall UK long-term savings strategy. Such conversations already happen but largely on specific issues rather than holistic strategy.

"Just because the group of experts is not a new idea doesn't mean it is not a good idea…the Joint Industry Forum on Workplace Pensions could be developed in this direction".

Within this policymaking context, what might be the long-term fate of PF? The good news is that the government has quickly set about removing an immediate obstacle to realising the benefits of the reform. By replacing quasi-compulsory annuitisation with a new compulsion to decide between several options (including the option to do nothing), the freedoms have made the retirement process more complicated for most people, exposing the widespread need for advice beyond the constraints of Pension Wise and accentuating the post-RDR advice gap. Assuming the Financial Advice Market Review (FAMR) achieves its stated goals, the scarcity of affordable, accessible guidance and advice for Middle Britain should eventually become yesterday's problem. With greater political muscle behind it than most regulatory consultations, there is cautious optimism that FAMR stands a good chance of delivering. That mid-market demand for general financial advice exists is broadly accepted: caution springs from the low penetration of simplified advice and perceived ambiguity around where regulated advice ends and guidance begins.

"27% of people who did a Pension Wise session with Citizens Advice Bureau (CAB) then went on to do a general CAB session to discuss debt, benefits etc. This suggests a demand for a holistic financial advice service"

However, whilst the freedoms have proved a catalyst for change in the advice and taxation regime, their long-term success is above all dependent upon one factor: accumulation. To address the pitifully low levels of adequacy - one firm estimates that over 80% of members of an actively sponsored scheme are unlikely to reach Turner replacement levels – policymakers have two levers: tax relief to provide an incentive to save, and AE to make it easy to save.

The New Zealand (NZ) Commission for Financial Capability is an autonomous crown entity that reports and provides advice to the government on retirement related issues with an overarching aim to ensure that the NZ system of retirement income can remain socially, economically and politically sustainable for decades to come. Responsibilities include:

- Leading and coordinating the National Strategy for Financial Literacy to improve the financial capability of New Zealanders
- Reviewing and reporting to the Minister of Commerce every three years on the retirement income policies implemented by government
- Monitoring the effects of retirement villages legislation, administering the retirement village disputes process and appointing members to disputes panels as vacancies arise

A standing group of specialists would lend ministers valuable independent support

Ultimately PF success depends on the success of AE

The success of AE remains not assured

The AE regime will need to become more prescriptive if pension pots are to become more material

Whatever the outcome of the consultation on incentives:

- we expect that any reforms will be tax positive for the Exchequer in the short-term at least (namely flat rate or something similar)
- we hope that the new system will be simpler both for consumers and providers. History suggests the former may be easier to achieve than the latter
- we wish that the new incentive accelerates growth in accumulation beyond AE minima and so has a positive effect on the savings ratio. But the thesis that tax breaks merely determine the destination of savings rather than increase the amount saved remains convincing

The stakes are high: ultimate success of PF hinges on material growth in accumulation but as things stand, the more people contribute to pensions, the greater the strain on the Treasury during this time of enforced austerity. It is arguable that, should pensions tax relief be materially reduced, most AE members and employers may continue to make contributions at the minimum level. However the important long term risk would be greater reluctance among employers to reward employees by contributing above AE minimums and among employees to contribute above minimum levels. Should any redesigned incentive fail to deliver increased savings, both AE and PF could be undermined.

AE is a well-intentioned step in the direction of shifting the UK's predominant debt culture towards the savings culture seen in some international markets. With relatively low initial contribution rates, opt-out has been lower than envisaged but eventual success is by no means assured:

Access to pensions assets can impact engagement rates

In Canada, the Home Buyers' Plan allows a withdrawal of up to $25,000 from the registered retirement savings plan to buy a home. There is also an opportunity to use this plan again as long as previous loans have been repaid and the borrower did not own a residence in the last five years. In NZ, the KiwiSaver, a voluntary work-based savings initiative, allows members to withdraw all or part of the savings early for buying their first home, emigrating, suffering financial hardship or serious illness. More than 70% of working New Zealanders consider KiwiSaver to be a good or excellent way to provide for their retirement. A recent study found that 63% of members had checked their KiwiSaver balance in the past month, and a further 26% had checked their balance in the last year.[2]

- opt-outs are expected to be higher among SMEs
- AE may merely redistribute savings, not add to the total, as a false sense of security may lead some members to invest less or cease non-pensions savings
- AE's coverage is limited, currently excluding the self-employed and lowest paid. In particular the self-employed, at 4m and rising, are an increasingly important part of tomorrow's 'Uber' economy

[2] KiwiSaver Evaluation, 2012-13

- when contributions rise by as much as four or five times in 2017/18 from the modest introductory level, opt-out levels could climb significantly.

"AE is a good baby-step but even by 2017-18 contributions will still be only 8% when DWP recommends 12-15% and many think that's an under-estimate"

Ironically it may be that the very inertia and disinterest AE was designed to overcome may protect consumers from this particular cliff edge.

"Members may go along with the 8% ramp up, many will assume from their payslips it's unavoidable like tax and NI"

This imminent cliff edge for AE in 2017/18 may coincide with a further extension of state pension age (SPA), and the combination of the two could reveal fault lines in the 'soft compulsion' strategy for accumulation. The increases in SPA have thus far caused less political flak than might have been expected but this may alter when we are faced with further rises, in particular for manual workers confronting the physical challenge of continued labour.

"Pensions may be re-politicised when the losers are clear"

In our view, as these longer-term impacts of AE become evident, policy on accumulation will need to become more prescriptive in order for the decumulation freedoms to bring material improvements to retirees. Whilst in the short-term there may be some softening of the AE conditions in order to give firms more time to comply or a lifting of the lower limit on firm size (from one to, say, three employees, the so called 'nanny' factor), firmer measures will be needed to ensure AE lands where it was intended to. Such measures could include:

- auto escalation (or other ways to increase contributions)
- ease of consolidation
- compulsion
- extension to self-employed
- extension to lower/variable pay

We recognise care must be taken when escalating member contributions to dull the pain of parting with more money and mitigate the risk of increased opt-out. However, if policymakers are bold enough to introduce measures to galvanise pensions accumulation in ways that materially increase average retirement pots, this could:

- dilute the risk that AE merely diverts savings that would have been made in non-pension vehicles, with members mistakenly assuming 'job done'
- increase levels of engagement over time as members accumulate more significant account values earlier in their careers, with amounts sufficient to motivate a more active interest in planning to finance life after work

"Members pay attention to pensions when their pot is as big as their annual earnings"

Provided the AE nettle is fully grasped, the focus on decumulation reforms will lose its current prominence as policymakers refocus their attention on the main event, accumulation. The long-term effects of an effective AE regime would lead the UK towards the more mature US market in which the notion of a pension is all but gone. Policy is now more focused on helping consumers to develop good savings discipline during peak earnings years, by enrolling members at default rates with AE to drive adequacy. This approach has had more effect on adoption and savings rates than mainstream financial education.

Average pot size vs the pot required to retire on minimum wage equivalent

£54,071

Average value of UK private pension funds, 2014, converted into an annuity

£217,000

Average value of pension fund required to retire on minimum wage equivalent (£13k p.a.)

£116,900

Average value of private pension required to supplement state pension and retire on minimum wage equivalent

% of people with pensions below that required to retire on minimum wage **86%**

Source: Association of British Insurers, 2015

Policymakers' focus is expected to return to accumulation

Customer - the long road to freedom

PF decisions require improved levels of engagement and capability among consumers, and the challenge is cultural as well as educational.

This chapter looks at the two main customer goals for policymakers, regulators, employers and the industry in this respect, and at how AE and guidance and advice could drive customer engagement in the UK. However, the boost provided by AE will materialise only as contributions and account values become more significant.

To fill the advice gap in the UK requires an understanding of demand-side issues as well as supply-side. As this chapter explains, the at-retirement segment provides an opportunity to explore demand-side issues and to sandbox-test a new guidance regime.

Most consumers are neither sufficiently capable nor engaged to assume responsibility for making PF decisions

For customers to make use of their new freedoms and take ownership of their choices will require significantly improved levels of engagement and capability. Engagement in this context means an emotional or intellectual interest sufficient to make someone act. By capability we mean the skills and knowledge needed to manage personal financial affairs. Such responsibility is new for most people and can only be assumed when they have the tools to play a more active role.

"The new policy landscape…is effectively a self-selection model…underpinned by an equation of responsibility that, frankly, we have not seen before. Political responsibility certainly, as well as industry and policy making. But also, crucially, consumer responsibility."
Martin Wheatley, FCA NAPF conference, March 2015

The shift required for consumers to take on this new role is as much a cultural challenge as an educational one. Even assuming our 'glass half full' scenario, with policymakers taking a consensual long-term view, a coherent UK strategy for long-term savings, and AE moving up through the gears, the shift from a debt to a savings culture is unlikely to take less than a generation. Groundwork by the Money Advice Service (MAS), The Savings and Investments Policy project (TSIP), the Financial Inclusion Commission and others has already begun. However, after decades of a paternalistic pensions culture in which accumulation and decumulation decisions were largely taken for customers, we should not expect them to assume responsibility for their financial affairs in retirement overnight.

"The fact is employee engagement is weak, education and promotion does not work, you need to 'Do it to the people, for the sake of the people"

"Why spend money on educating people when they don't want to be educated about this stuff? There's a cultural difference compared to the US who have taken the education route. The starting point is too late for us now to address the issues facing today's generation of savers"

Two customer goals should be set: build foundations to improve capability and use PF momentum to boost engagement

"Consumer education is often proposed as a remedy, but to my mind it's a real stretch to ask people to acquire sufficient financial expertise to manage all the investment steps needed to get to their pension goals. That's a challenge even for professionals. You'd no more require employees to make those kinds of decisions than an automaker would dump a pile of car parts and a technical manual in the buyer's driveway with a note that says, "Here's what you need to put the car together. If it doesn't work, that's your problem."" [1]

Incentivising employers to incentivise employees to save more...

401k plans: Default enrolment and auto escalation

- Employers are incentivised to drive up participation and contribution rates
- Employers' contributions to their own pensions plans are capped depending on the participation and contribution rates amongst employees
- Industry has moved towards default option and auto escalation to overcome low take-up and/or contribution rates

Over 60% of US companies offer 'Save more tomorrow' (SMT)[a]

- The initiative draws on behavioural economics to increase employee saving
- Study of initial effect showed:
  - 78% of employees offered the SMT plan opted in
  - 98% who joined the plan remained in through two pay rises, and the vast majority (80%) remained in through the third pay rise
  - Average saving rates for SMT plan participants increased from 3.5% to 11.6% over the course of 28 months

[a]Allianz Global Investors, Centre for Behavioural Finance, 2015

Source: KPMG - illustration purposes only

US experience suggests that AE and auto escalation have proved more effective than education alone in instilling better savings and investment behaviour (see illustration).

Although it may take a generation for all the political and commercial investment in pension reforms to pay off, we have to start somewhere. Two medium-term objectives are required:

- first, to lay the foundations to improve consumer capability as a basis for a durable savings culture. Policymakers must accept that this task will extend beyond the current political cycle and the benefits may fall to Millennials rather than Generation X or Y
- secondly, to use the momentum created by pension reforms - PF in particular - to boost consumer engagement

The first objective will require recommitment to a Financial Capability stratgey for the long-term, building upon the FAMR and Public Financial Guidance consultation. This remains a logical goal despite the fact that based on experience in the UK and abroad, there is no evidence that mass education delivers the step-change required in financial capability.

"Most employee education programmes I have known have failed"

"There are over 300 UK entities involved in financial education but what is needed is practical nudging more than formal teaching. Yes it's on the national curriculum but investment is left up to each LEA, there's no central funding. After all, it's a life skill, not maths"

If there is scepticism about the benefits of holistic education, there is also experience that well targeted, strongly sponsored communications can be effective.

[1]The crisis in retirement planning, Professor Merton, HBR 2014

"...the right message to the right audience at the right time that is clear, relevant and recognises behavioural finance biases can work. Policy implementation should adhere to behavioural finance techniques because people are not rational about money"

For as long as capability remains low, the key to improving understanding of financial matters is event-driven, timely communications which catch people's attention. As and when AE becomes more prescriptive, it will be critical to support it with a sustained communications programme from both government and schemes, such that employees attach more value to membership at higher levels of contribution. With so much invested in the reforms, this would seem politically expedient at the very least.

The second objective - raising levels of consumer engagement - is a more realistic short-run goal for which there are two main levers: AE and guidance.

History shows that UK consumers have periodically been sufficiently engaged to change their financial behaviour. Examples include privatisation and demutualisation share ownership, council house purchase and buy to let schemes. Admittedly in most cases there was (or was perceived to be) an element of instant gratification supported by the heft of a 'Tell Sid'-style heavyweight marketing campaign. In practice, people tend to engage when they have to – for example, to buy a house, to deal with a crisis or an inheritance, to manage a retirement pot.

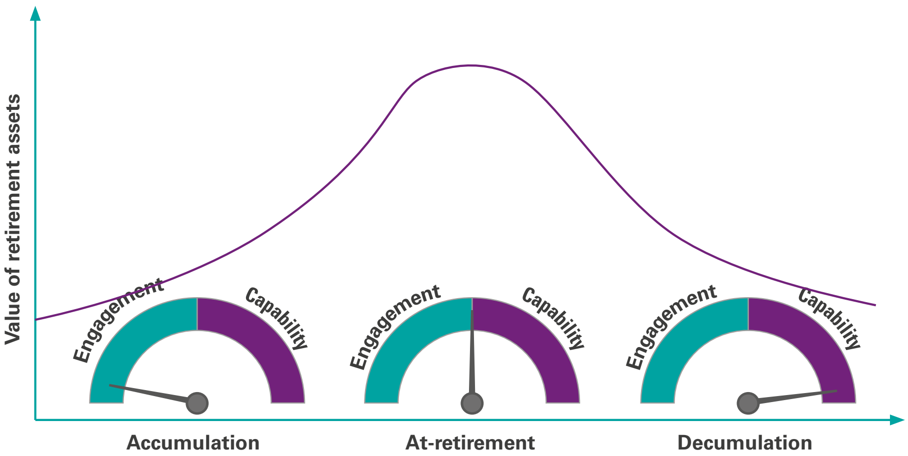
"We risk being too patronising about people's financial literacy - when they are engaged they bone up on the odds on a place versus a win at the 4.30 at Kempton Park"

Although unproven on a larger scale, making it easy to save small amounts on a regular basis may boost engagement levels, for example through initiatives such as 'save the change' schemes.

Practitioners believe targeted communications work better than holistic education

Raising consumer engagement will be driven by AE and guidance

Engagement is highest when inaction is not an option



Source: KPMG – illustration purposes only

AE will raise engagement but only in the long run

The opposite is also true: when people are not engaged, they have less opportunity to act in ways that are economically rational, for example the low take-up of current account switching is surprising to many.

By offering benefits that are more immediate and tangible, such as employer contribution matching and account values, AE can be expected to raise levels of engagement with saving for retirement, albeit gradually over the course of many years.

"AE may mean lots more people will save more but they will not be engaged in saving"

It is arguable that the passive nature of AE and auto escalation cannot in themselves make consumers more interested in saving for the long-term. Nevertheless, we think that when the size of people's accounts becomes worthy of attention, and when this is communicated effectively, consumers may become more engaged.

"People only want to know about pensions once they can take their money out; prior to that they are not interested."

Whether or not AE eventually tilts us towards more of a savings culture, a prerequisite for PF itself to work in the long run is that people accumulate amounts sufficient to render their new choices at retirement meaningful. To a greater or lesser extent, AE will increase accumulation regardless of scheme members' levels of engagement. The focus of all stakeholders should be to ensure people are sufficiently engaged by the time they retire to choose appropriate options.

The necessity for customers to make choices brings us back to capability for, as long as capability remains low, the availability and usage of guidance and advice to support retirement decisions will be critical. Guidance and advice is the second lever for increasing engagement, and the outcome of FAMR will determine how effective this lever proves to be. The majority of retirees fall into the advice gap, ie between those wealthy enough to pay advice fees and those with smaller pots with no need of advice.

So without wishing to pre-judge the outcome of this important review, we offer comments on the advice gap and potential solutions in the context of events leading up to and at retirement.

The advice gap exists because of industry concerns around liability and economics - ie, the conduct and Financial Ombudsman Service (FOS) risks attaching to advice, combined with the high cost of delivery, outweighed the potentially low margins that Middle Britain would support.

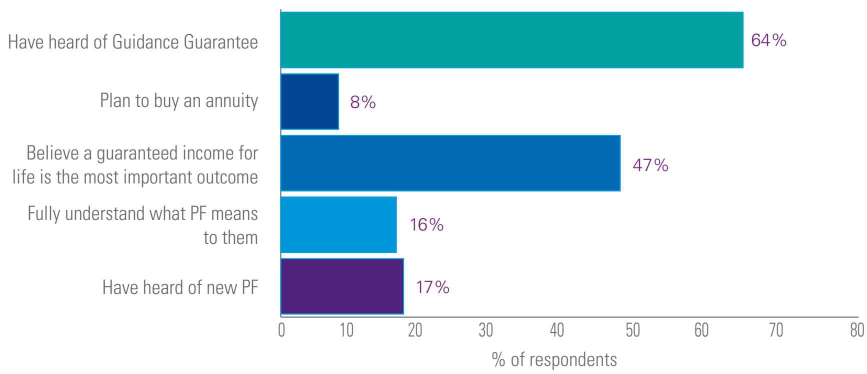
Any adjustment to liability for whatever 'advice-lite' regime may emerge from FAMR will clearly lie in the hands of the regulator but policymakers need also to bear in mind two relevant factors. First, that post-PF, the complexity and unpredictability of financial needs in retirement mean there is never a single 'right' answer. Therefore the role of guidance is to help customers make decisions that achieve good outcomes, if not necessarily what used to be called

'best advice'. Secondly, any new guidance framework must allow scope for firms to earn a return. As previous attempts to bridge the gap have shown, from Sandler stakeholder products to simplified advice, if the balance of liability and profit is unattractive, commercial investment will not be forthcoming.

PF have already catalysed new digital and telephone-based advisory models that drastically reduce paper- and leg-work, some offering dramatically reduced fees of under £200 for full advice for a personal recommendation. The market is still in the experimentation phase and in a perfect world, we would know the outcome of

Any new guidance regime must be affordable to consumers and attractive to industry in terms of economics and risk

Consumers' pensions understanding



Source: Income Reality Survey Report, M&G investments, 2015

The advice gap is not just a supply-side issue

A new guidance regime should be sandbox-tested in the at-retirement segment

the experiments before FAMR reached its conclusions. What is clear already, however, is that bridging the gap is not a simple supply-side issue, a matter of reducing delivery costs and consumer prices to harvest latent demand. After all, if price was the big hurdle for consumers, why was there not higher take-up of free guidance from CAB, MAS or The Pensions Advisory Service (TPAS)?

One of the by-products of the historic paternalistic pensions regime is that most consumers are unaccustomed to seeking savings and investment advice, something accentuated by RDR. Consequently, one of the reasons why many people are reluctant to seek guidance and advice is a low appreciation of its value. That being said, there are potentially important generational differences here. Today's younger accumulators are less likely to have been part of yesterday's paternalistic DB and annuitisation culture. In the internet age, consumers instinctively perform their own research to support buying decisions. They are more willing to share information online and are actively influenced by the opinions and recommendations of others. Such behavioural trends suggest a favourable outlook for digital advice and investment services over the long term.

In view of such demand uncertainties, it would make sense to take a Project Innovate approach to any new guidance model, ie to road-test how it works with actual consumers under controlled conditions. The at-retirement market under PF offers a tailor-made segment in which to conduct such testing, given the following characteristics:

- demand for guidance is not latent and its availability is mandatory
- the customer need is immediate and material to quality of life
- options are new and complicated
- there can be a degree of certainty around retirement outcomes

A new guidance regime for retirees could harness the momentum created by PF and gain traction more rapidly among Middle Britain. Creating a guidance regime that improves consumers' engagement with their new retirement choices would not only help to secure the long-term success of the freedoms but also represent an important step towards building a lasting savings culture.

Innovation – only connect

Policy has been the disruptive driver of pensions innovation, and the introduction of PF will again encourage firms to innovate. Whilst product innovation will be important, we believe that innovation around guidance and advice will prove even more influential.

This chapter considers both aspects, looking at the future for annuities or retirement income for life (RIFL) products, and the emergence of universal accounts (UAs) to help customers manage multiple sources of income and asset classes.

Also examined in this chapter is the profound innovation in advice services likely to be triggered by PF, including robo-advice. Digital will be equally as important for automating advice and investment processes as an engagement tool to attract customers and understand their needs.

In this scenario, the threat of disruption is greatest at the customer interface rather than product, asset management or administration. The challenge to incumbents will be cultural as much as commercial, and the industry will need to invest in common standards and infrastructure if it is to achieve a step-change in costs and efficiency.

The pensions market has experienced more disruption than nearly all financial sectors. The primary disruptor has not been technology, consumer behaviour or new entrants but policy. Innovation has primarily been driven by new rules, regulations and regimes which have caused firms to reshape products and processes to comply with them.

PF will differ from previous more prescriptive reforms such as AE. In dispensing with quasi-compulsory annuitisation and liberalising customer choices at retirement, this reform invites industry to innovate. Such innovation will shape the future retirement marketplace, chiefly in product design and the advice experience.

We expect that in time new ways of delivering guidance and advice will prove more capable of influencing consumer behaviour than product design, even if in the immediate future low capability and clunky consumer protection processes will drive many customers towards the quickest outcome.

"There is a significant customer cohort that is not interested in optimal outcomes, but whose preference is the 'path of least resistance"

Product designers face two interdependent challenges. The first relates to the initial at-retirement period, the second to how consumer needs change and evolve during the various phases of the retirement years.

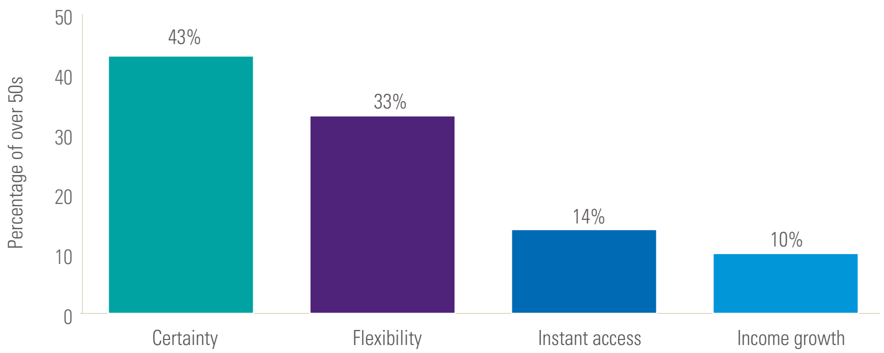
Whilst the annuity has become a tainted brand in the eyes of some, repeated studies indicate that for many people the retirement income product of choice would produce a guaranteed income for life, have inflation protection, protect a surviving spouse and so on. If there is participation in equity markets, that would be nice too.

"Annuities have a bad name as they are, but if they can be re-branded they should recover as research shows people like guaranteed income"

"A modern with profits policy would be ideal, with smoothed returns and a mix of growth and guarantees"

Policy has been the disruptive driver of pensions innovation

Top priority in retirement income for over 50s, August 2015



Source: Retirement Sentiment Index, Retirement Advantage, December 2015

There is a healthy future for re-branded, better value, better targeted annuities

The design of RIFL products or whatever annuities become known as, will be driven by two factors.

Subject to final outcomes from Solvency II, they will become demonstrably better value for money. Much of the perception of poor value resulted from the industry and regulator's inability to increase shoparound among customers, especially those with smaller pots. Nevertheless, for this to happen a proactive repositioning will be required. This will not simply be driven by lower distribution costs and better pricing but will also arise from providers' strenuous efforts to convey the value of lifetime or fixed-term guarantees and smoothing.

Secondly, now that the 'one-size-fits-all' regime is no more, RIFLs will become better targeted to the needs of individuals, or at least to more defined segments of customers. Over time advisers and providers will become more adept at identifying and interpreting the financial and behavioural traits that influence buying habits and lifestyle, and then tailoring products accordingly. This trend will build upon the approach to segmentation already established by enhanced and impaired annuities and upon innovation in blended decumulation products which add flexibility to the guaranteed income benefits. Whilst it may not result in the invention of entirely new RIFL structures, innovative combinations of existing components – underwritten, fixed-term, deferred and variable annuities – will emerge. Time will tell how successfully industry manages the balancing act between providing flexibility and maintaining the appearance of simplicity.

Universal accounts will emerge which help customers manage multiple sources of income and asset classes

To wonder whether any RIFL products will become the new decumulation default is to miss the point of the reform: PF removed not only lifetime annuities as the effective default but also the concept of a default retirement income itself.

Although the idea of a pension as a bank account caused much gnashing of teeth in the industry, the underlying point that people want greater flexibility will become an accepted design principle for retirement income solutions. The industry will therefore move beyond the current phase of building solutions from product components, appropriate though it may be, towards solutions which integrate data and tools to enable customers to get more value out of the variety of assets they own.

So what may emerge over time could be less of a current account and more of a UA through which customers manage multiple sources of income across different asset classes – not only pension pots but also non-pension savings in deposit accounts, ISAs, property and equity release, rental income and so on. In this way, the design of UAs derives less from how providers see the world and more from how consumers regard saving for retirement.

The popularity of investing in property, most people's only viable opportunity to leverage gains, shows how consumers already and necessarily take a more diverse view on sources of retirement income. For example, we expect the drawing-down of home equity to become a more material product area, whether to supplement pension income or linked to long-term care fees.

At their most basic, UAs may be simply reporting platforms or data aggregators, for which much of the technology exists already. They will build upon the eventual arrival of some form of pensions dashboard to help consumers understand and manage the accumulation of savings across different vehicles so that they reach the at-retirement stage better prepared.

As has been identified by the FCA and elsewhere, there are international examples of successful initiatives to improve consumer engagement through virtual dashboards, such as those in Sweden and Israel. However, building such services is a material undertaking: the 'Minpension' in

Sweden was 10 years in development, and it took regulation to force industry to enable consistency of format and data sharing, critical to ensure consumer engagement.

For consumers with more complex needs or greater income-producing wealth, the UA will eventually take on more financial management functionality. Such accounts will be run on both an advised and a non-advised basis, and encompass both accumulation and decumulation. UAs will adopt advice and guidance tools that are already becoming deployed on a small scale, a trend that will accelerate, assuming pragmatic outcomes from FAMR.

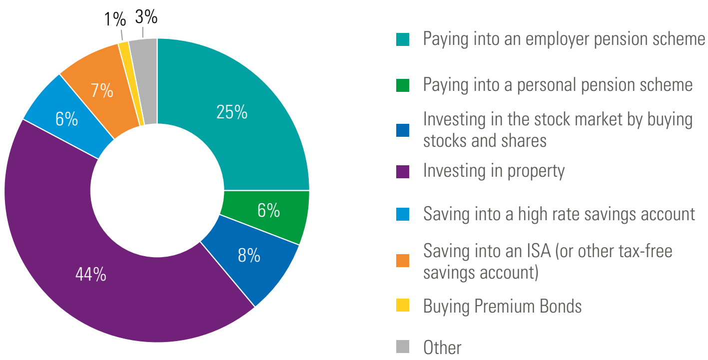
This brings us onto guidance and advice, the logical next step in the sequence from product and solution. The Chancellor's use of the word 'advice' when describing the guidance guarantee in his 2014 Budget speech may have raised eyebrows at the time. However, in retrospect the joke may be on the industry and its regulator if the underlying message was 'people will need more help with retirement choices than is currently easily accessible; neither I nor the voters care if you call this advice or guidance or information so I suggest you sort it out'.

Innovation in the delivery of advice (with a 'small a') will be the most profound secular transformation triggered by the PF. For this reason, it is to be hoped that FAMR builds upon the momentum created by the reform: if it fails to make consumers' lives easier at a time when the need for advice is nationally promoted, it is unlikely to work for investment needs where seeking advice is merely discretionary.

Much of this innovation will be enabled by technology but the game-changing advance will lie, as ever, in how the technology is deployed. As in the US where technology-enabled retirement and investment planning tools have taken many years to gain traction, the UK may only find successful commercial models after some years of experimentation.

Which do you think would make the most of your money?

Consumers believe investing in property 'would make the most of' their money.



Source: Wealth and Assets Survey, Office for National Statistics, 2015

Certainly across the Atlantic, online tools delivered with human support – the so called 'cyborg' model – have achieved penetration beyond 'robo' self-service models. The UK is also likely to follow an omni-channel model, although the mix of advice and guidance propositions across channels and media will follow different lines to the US with its longer tradition of self-provision and absence of quasi-compulsory annuity purchase.

PF will trigger profound innovation in advice services

We expect the growth of automated advice and guidance to be characterised by three factors:

First, in a relatively short time the market will cease to label digital services as 'robo' or even the more appropriate 'cyborg'. Robo-guidance or advice will become merely guidance or advice in much the same way as we might say 'I bought a book on Amazon' rather than 'I made an online purchase at Amazon'. Digital has become part of everyday consumption and will eventually permeate retail investments as it has permeated retail banking.

Robo-advice will soon lose the 'robo' label

Sweden's Minpension initiative

- 2.3 million Swedes use 'minpension' (my pension) out of 5.4 million eligible working population users. Run as a public-private partnership, it provides simple and comprehensive material on pensions, and offers advice on how best to manage pensions funds.
- 'Minpension' is based on a system of electronic certificates which provides a single sign-on, whether people access through on-line banking, their long-term savings provider or directly.
- Users report a substantial increase in their pensions knowledge and an increase in consumer trust.
- However, building the service was a material undertaking with 10 years of development, stressing the need for long term commitment by key stakeholders

Source: Retirement 2050, Association of British Insurers, 2015

At-retirement advice will evolve into through-retirement planning and monitoring

Secondly, advice propositions will evolve from being mainly transactional – ie, in support of point decisions on when to retire or the assets needed to retire or what retirement income products to purchase and when – to retirement planning, income modelling and the monitoring of progress against plans. Not only has life expectancy become widely variable but the concept of retirement as an event has given way to an indeterminate period of transition. It is therefore mission-critical for the PF project that better ways of supporting these 'transitioners' are developed. This is a more sophisticated challenge than servicing demand for event-driven support because it requires technology to replicate some of the ongoing, relationship-based processes that are at the core of IFA services and typically contain a face-to-face element.

"Algorithms are good at doing some tasks but they can't recognise the nuances and constraints that a human adviser can…we don't believe people can be totally replaced by robo-advice. What's the digital tool to replace 'the man from the Pru' mentality?"

It is one of the striking paradoxes of the internet that the more information, tools and services become available online, the greater human intervention is valued. We believe blending automated and human intervention will prove to be more an art than a science. Diverse players are already working on different approaches including technology firms, traditional IFAs, online wealth managers and most leading providers and EBCs, which gives us confidence that solutions will be developed successfully if not immediately. Significant advances in using Artificial Intelligence (AI) to provide professional guidance have already begun in other industries such as health.

We expect no single dominant model will emerge, rather a variety of ongoing engagement models that suit different behaviours, preferences and budgets. As many firms have already found, one design principle unlikely to succeed is slavishly translating the language and processes of offline methods into online and mobile.

Finally, it is received wisdom amongst policymakers, regulators and the industry that digital technology will play a critical role in bringing affordable, accessible guidance and advice to Middle Britain. The potential supply-chain economies are within touching distance but what we don't yet know for sure is how much Middle Britain actually wants this. Rationally, people should use low-cost, online support services - just as rationally, many more should use PensionWise and TPAS. The problem is, financial behaviour is seldom driven purely by what is rational, hence the wide acceptance of behavioural finance principles. The point here is that PF has caused the pensions industry to embark on a transition from a largely manufacturer / wholesaler model in which it did not need to know its customers as individuals, to one in which it must engage and understand individual customers before the end of the accumulation phase.

"Firms are not generally good at understanding customer needs or segmentation…communication is compliance-driven, annual statements are often impenetrable"

This is where, aside from automation of advice and investment processes, significant investment will be made in digital to power engagement tools that not only cause consumers to reach out but also enable firms to understand and so segment their needs. Leading firms will master this layer and use it to inform and tailor their propositions, something that is second nature in the consumer retail sector but results from years of test and learn.

Thus, there is clear scope for innovation but what is the threat of disruption posed to incumbent firms by new models or entrants? The door opened to potential disruptors by inefficient legacy systems and infrastructure remains ajar and we may see a further wave of legacy consolidation as disruptors exploit incumbents' cost disadvantages. However, the long-term threat is greatest not in the industry heartland - manufacturing products, designing and administering schemes, asset management and so on – but around the customer and in particular how quickly firms learn effective ways to understand and engage with customers. This is as much a cultural as a commercial challenge for firms.

Automated guidance in the health sector

IBM's 'Watson' began life as a 'reasoning engine' that in 2011 defeated two former winners of the US quiz Jeopardy, answering questions in natural language. It remains early days in AI but Watson has since begun to help physicians' diagnosis and treatment planning. Its 'answers' are:

- based on all available medical knowledge
- accurate, evidence-based and free of cognitive biases
- consistent; given the same inputs, Watson will always output the same diagnosis
- have very low marginal delivery cost once built
- can be accessed anywhere in the world through a computer or a phone

"Firms think they need to educate consumers better so people understand financial services. In fact, it's our industry which needs to understand our consumers better"

"Are institutions capable of innovating around the customer? So long as they organise P&Ls around products, how can they move to being driven by customer value?"

It is not that earnings from product manufacture and asset management will necessarily decrease across the value chain. It is rather that the gatekeeper to customers will cease to be their employer or their employer's adviser or trustee, though each may support their members' retirement decision-making. The gatekeeper will be the customers

As well as automating advice, the critical role of digital will be to power engagement tools

The threat of disruption is greatest at the customer interface

Customers will eventually become their own gatekeepers

Industry will also need to invest in infrastructure

themselves, and their chosen adviser, which is why digital tools for engagement, segmentation and decision support will be a key battleground for innovation.

"The industry is vulnerable, it has to form the customer relationship in accumulation phase"

Whether this will amount to genuine disruption, a material reallocation of value chain economics, is debatable. On the one hand, it is a distinct possibility, encapsulated by one quote in our research:

"Why would ours be the only industry not disrupted by digital? If incumbents don't harness technology, an Uber disruption will happen"

On the other, the lesson of history is not to overestimate the speed of change in financial services, the last industry, according to Sir Brian Pitman, to undergo an industrial revolution. In the long-term, both views may be borne out, echoing Bill Gates' sentiment that we tend to overestimate the speed of technology change but underestimate its impact.

Finally, in addition to individual firms investing in the higher-profile areas of innovation discussed above, we expect progress at an industry level. Compared to other sectors like energy or banking, the retail investment and pensions market is notable for its lack of infrastructure and for the cost and friction that result in the supply chain.

"We need to agree common standards and infrastructures akin to what Visa and MasterCard did to the credit card market to create infrastructure for a successful industry"

"The pensions industry needs infrastructure as in banking, to lubricate flows, help consumers consolidate…this could be part of what George Osborne meant by 'bank account' as pensions are far behind banking…some of the worst problems are in occupational pension schemes. The administration of some schemes is 19th century"

In the past, when consumer bargaining power was weak, it was not necessarily a rational economic decision for individual firms to contribute to industry infrastructure. But the industry now faces more interventionist policymakers who will not be shy 'to make progress for' the industry if it fails to make progress itself. Intervention may either be on competitive grounds from the FCA or on political grounds to secure the success of pension reforms by the government.

Industry infrastructure is partly a function of the sector being far more diverse and fragmented than retail banking or general insurance, with a wider range of players and multiple regulators. Infrastructure has been put in place by and for component parts of the industry: for example, Origo Options for pension transfers, TeX for re-registration of assets, a Common Quotation Form for annuities. However as previously discrete parts of the broader long-term savings industry increasingly overlap and converge, the need for an over-arching strategy for infrastructure becomes clearer. Despite the industry's progress towards agreeing common standards and protocols, we expect intervention to give renewed impetus to building infrastructure.

Business strategy - survival of the most adaptable

In the new pensions landscape, retail and wholesale value chains will inevitably converge. This chapter examines what this may entail and looks at the capabilities required to succeed.

Mass customisation, an omni-channel approach and trust will be critical. Vertical integration will give advantage to customer-centric firms that are competitive in more than one role, but there will also be space for specialist boutiques and low-cost operators.

The chapter ends by looking at possible new entrants and disruptors which are likely to test the adaptability and resilience of incumbents, and by identifying the models and propositions from previous years that may well re-emerge in different guises.

If PF have made life more complicated for retirees, the same is doubly true for pension firms. The reform has thrust this intermediated, wholesale market towards a complex landscape with multiple default options, longer investment horizons, greater product diversity and, most challenging of all, individuals as well as corporates needing help.

To compound this complexity, the market environment will remain volatile. Many of the policy changes that will shape the market are outside this report's focus on PF but plausible assumptions need to be made in order to map the strategic context:

- we do not expect a prolonged period of stability from policymakers as they strive to join the economic, social and political dots on policy for later life. However, it is to be hoped that AE, PF, and tax and advice reform will be left to bed down
- we expect a new guided savings regime to sit alongside regulated advice and to reacquaint Middle Britain with the habit of long-term saving, in the workplace and beyond
- a new form of tax incentive for pensions seems inevitable, most likely one that appeals to large numbers of voters but also satisfies HMT (if not, to the same degree, the industry)
- AE may be made more prescriptive in order to raise contributions towards meaningful levels, through measures like auto escalation and increasing coverage to lower-paid and self-employed workers
- the legacy of the banking crisis and the various mis-selling debacles will not quickly recede from public consciousness: it will remain difficult for institutions to win the trust of customers but less so for firms not perceived to be tarnished by historic failings

PF have added a layer of complexity to a largely wholesale market

Retail and wholesale value chains will converge

Against this backdrop, we believe that retail and wholesale value chains - in most firms, largely separate - will inevitably converge as firms increasingly serve both corporate and individual customers that are part of the same entity. How this scenario unfolds depends on several questions, which will be considered in this chapter.

How much value to play for?

AE fund price capping and post-RDR price pressure have already accentuated margin pressure across the supply chain, impacting earnings in investment management, product wrapper and platform. We also expect further pressure in the long run on the retail decumulation market for two reasons. First, the AE accumulation price cap will increasingly influence customers' expectations for decumulation products. Secondly, the eventual outcomes of the FCA's retirement income market study and review of drawdown pricing are likely to sustain their balancing act of not being a price regulator whilst also fostering an environment that is hawkish on price.

Bargaining power of consumers and advisers will rise

Who will hold the power and influence?

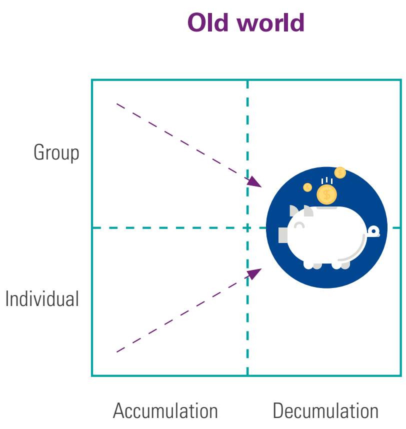
A net effect of PF will be to increase the bargaining power of retiring consumers (and their advisers). Over time therefore, proximity to the customer will determine the degree of influence over the allocation of value, as is happening in the post-RDR retail investment market. This evolution is likely to be slower than in the more mature wealth market since the majority of retirees are less capable, and whatever guidance regime emanates from FAMR will take time to gain traction. Firms competing in both accumulation and decumulation will gain potential advantage in the at-retirement market from having already initiated a customer relationship.

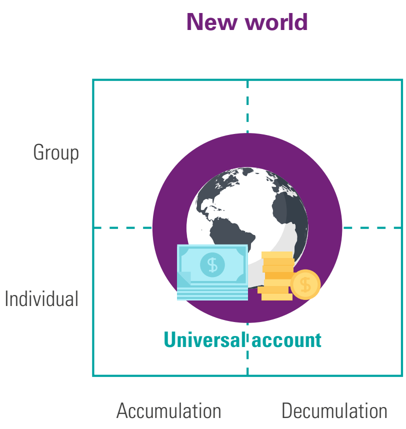
Convergence or integration…or both?

The last decade has seen rapid growth both in DC pensions and in retail investment platforms which support customers and advisers managing money across different tax wrappers and channels. These trends have blurred traditional boundaries between workplace/group and individual offerings and have been underpinned by an increased integration of core functions – marketing, operations, IT – to deliver a more comprehensive customer proposition.

PF have dramatically increased the overlap between accumulation and decumulation and will accelerate operational convergence and integration across the extended customer life cycle. Operational integration will extend across the supply chain beyond platform into distribution and investment solution design. Firms competing in both accumulation and decumulation will develop fully integrated models underpinned by a clear customer proposition and a coherent customer experience that is supported by CRM, channel management, data management, customer service, regulatory and IT capabilities.

New and old world pension





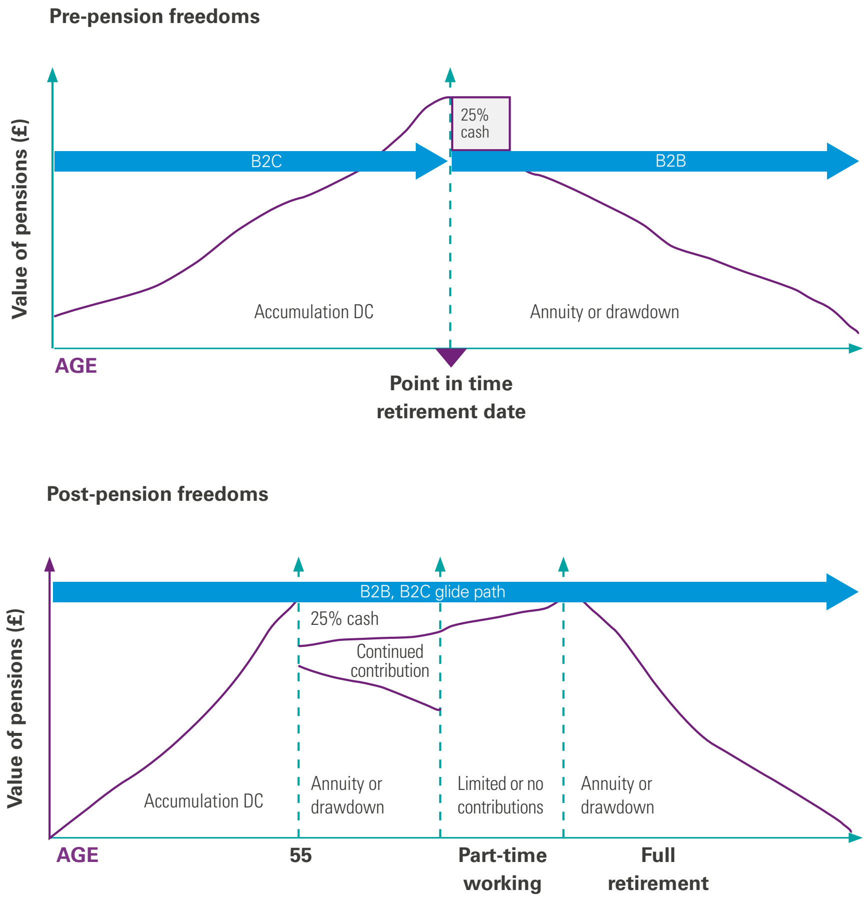
Source: KPMG – illustration purposes only

What will it take to win?

Above all, the over-used if under-implemented phrase, **customer-centricity** will determine success. As was clear from the Chancellor's opening rhetoric in his 2014 Budget speech, this reform is all about giving people control over what is theirs. The retail investment industry, responding to pressure from customers and the regulator, has largely accepted the imperative to place customers at the heart of the business. The largely B2B pensions industry has begun to follow but its challenge is more complex:

- **Who is the customer?** In the wholesale market, the customer remains corporates, trustees and their advisers, but within schemes the customers are members approaching an ill-defined retirement, retirees and former members in retirement.
- **Who owns the buying decision?** Not only has pensions reform introduced new scheme governance structures, but as members approach retirement, they will demand more say over glidepath and investment options before assuming personal control over retirement income choices.
- **Who owns the customer relationship?** How a corporate account transitions into a collection of individual customer relationships is not an exact process. Complexity will be driven by the diversity of behaviour of individuals taking control of their retirement decisions.

Changing glidepaths and decumulation periods



Source: KPMG – illustration purposes only

Pensions firms must place consumers at the heart of their business

- Adding this retail overlay onto a traditionally wholesale market will challenge firms' organisational design and governance. Previously it was feasible to operate in silos that were once described as 'double-barrelled', configured to deal with customers according to channel and product requirements that were largely discrete. Consequently, functions and business units have taken on distinct cultural identities according to whether they are retail or wholesale, direct or intermediated. A further layer of cultural division exists within both retail (IFA, partnerships, D2C) and wholesale (EBC, CIFA, IM-only, direct to corporate). Finally, members of schemes may also be retail customers…advised or direct!

Becoming more customer-centric will require increasingly sophisticated business models supported by more integrated and data-rich operating platforms that are organised around both corporate and individual customers. This will require major investment over many years. Choosing whether to participate will depend on incumbents' risk appetite and how attractive and accessible they regard opportunities across the evolving value chain.

In practice, we expect three primary capabilities will be needed to deliver genuinely customer-centric services under PF:

Customers will demand more tailored guidance, advice and propositions

Mass customisation: The age of 'one size fits all' at retirement has passed. The complexity of choices available to retirees with material pension and non-pension assets has manifestly increased, and the market challenge is how to provide services tailored to customers with distinct needs economically.

Customers' real or perceived need for tailored services is driven not simply by size of pot but also by complexity of circumstances and behavioural factors. This is the age of 'grannies on skateboards' in which people are defined by what they do, not what they are.

Firms' ability to identify and understand types of customer according to the strength of their appetite for tailored solutions will be critical.

Tailoring will take place across two dimensions: advice / guidance and proposition.

Bespoke advice has long been the domain of IFAs but the extent of human intervention and regulatory compliance involved makes conventional advice too costly for the average retiree. However, PF have catalysed further investment in automating regulated advice. As a result of this, and also possible post-FAMR developments, we expect more automated, decision-tree advice processes to enable 'off the peg' tailored advice and guidance that deliver a customer experience with a veneer of 'bespoke'.

We will also see tailored investment propositions continuing to 'trickle down' from wealthier segments into middle markets, and there will emerge retirement income solutions that can be tailored to individual circumstances.

Whether this will amount to genuine mass customisation is questionable. To be affordable, the degree of 'bespoking' is likely to be governed at a segment level – for example, in practice tailoring will apply to risk category rather than individual.

> "Mass customisation is probably still too expensive to deliver but 'off-the-shelf bespoke' is the way forward, providing a perfectly good fit but not fully hand-made at Savile Row prices"

Providers of solutions, guidance and advice will have to design propositions that accommodate the breadth of PF options but in ways that are economic to the needs of the type of customer. Pricing is always important but ease of use, streamlined processes and speed of transaction may be more influential with customers, judging by the number of retirees who shied away from free guidance in search of the line of least resistance in the early days of PF. The battleground will be customer experience and winners will be measured by customer satisfaction advocacy and retention.

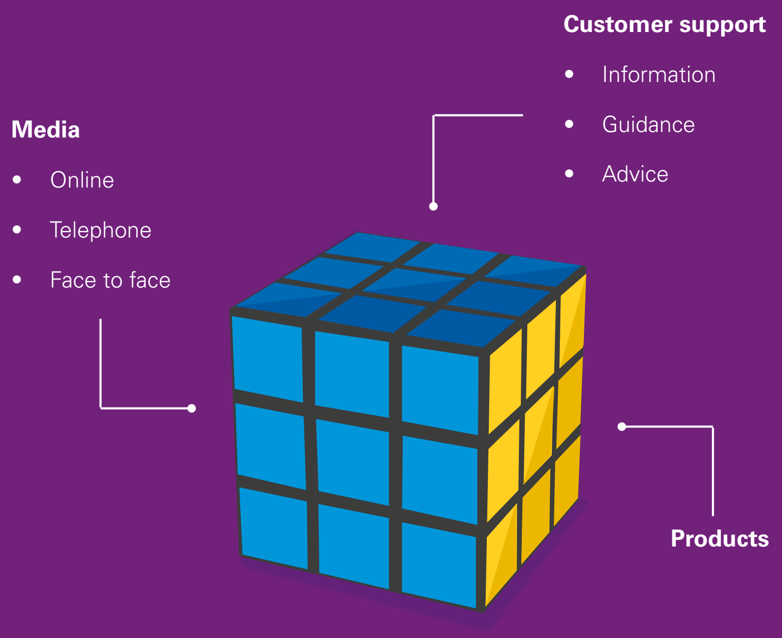
Omni-channel: Pension firms which choose to service the needs at retirement of individual members will follow the trend already evident among retail investment firms towards what has been described as the 'Martini Model', namely the delivery of services to customers 'anytime, anywhere, anyhow'. Indeed the availability of PensionWise via online, telephony and face to face has shown retirees' appetite to access guidance via different channels.

The challenge for firms to move from running perhaps one or two channels to the complexity of managing multiple channels and access media will prove arduous. Firms competing in the decumulation market must learn how to manage a 'Rubik's Cube' of a distribution model comprising multiple channels and media in one dimension and multiple product options on the other, at the centre of which sits the customer.

Many players have multiple channels and products already but competitive advantage will come from the orchestration of services to meet customer needs during and beyond the retirement process. Within this, the effectiveness of a triage system to segment customer needs upfront will be critical to starting customers off on a path that suits their preferences. As paths will seldom be linear, this process would be redeployed as required by customers or their advisers.

Trust: Finally, as retirement options become more complex, the role of trust as the glue that makes a customer-centric model work will become more critical. Just as consumer brands like Amazon or Easyjet consciously used books or air travel to build

A new distribution model



Source: KPMG – illustration purposes only

Winners in decumulation will transition from asset gatherer to customer gatherer

trusted brands as a platform to enter adjacent sectors, we expect pension firms to earn trust during the accumulation years to support decumulation branding.

Other areas like product, asset management, advice and guidance will remain important but this is more a case of optimising existing capabilities to stay in the game.

Who will be the winners?

We believe that four types of firms are well placed to flourish in the new era:

1. Firms that successfully build a customer-centric model and culture, recognising that proximity to customers and their advisers enhances influence along the value chain. Winners will be those who achieve the demanding transition from being an asset gatherer to a customer gatherer, a process that will involve cultural as well as strategic and operational challenges. Successful migration of legacy customers onto modern platforms able to support new propositions will be a mark of leading providers. The imperative to satisfy as many customer needs in-house as possible will necessitate waterfront product suites that can sustain scope economies. However, over time, as consumer buying becomes more sophisticated through advice and guidance and improved capability, purchasing behaviour will become more selective, seeking best-of-breed over single brand.

2. Faced with margin pressure across the value chain, firms that successfully vertically integrate to access greater value. Success as a VIF will not be determined by the starting point. As is already evident, manufacturers, advisers and distributors will pursue vertical integration, both organically and via M&A. Success will lie not simply in vertically integrating but in becoming strong in more than a single key role.

3. With the expansion of customer options, there will be space for decumulation specialists with focused expertise, largely targeting niche areas capable of sustaining attractive margin such as risk, product design and boutique asset management. These can be expected to congregate mainly but not exclusively at the wealthier, more sophisticated end of the market. The continued consumer appetite for guarantees and smoothing will ensure a future role for insurers' balance sheets, but asset management will increasingly dominate the decumulation landscape.

4. In a world of converging value chains and margin compression, high-volume, low-cost operators can generate scale economies. This is an especially hard road for those encumbered by costly legacy infrastructures, and not all firms embarking on this route will arrive at the destination.

In simple terms, losers in the new era will include firms which fail to achieve those four capabilities, but what determines winners and losers won't just boil down to how effectively a chosen strategy is executed. Firms must be prepared to make hard decisions, not just on strategy selection but whether to participate at all. Just because the market is transforming does not mean every firm must transform in order to participate. Some can thrive as specialists by becoming better at what they already do, perhaps as component providers for other firms' solutions. Others may survive by not participating, for example allowing their legacy book to run down naturally over time or to be consolidated. Such firms will accept when the risk/reward equation is unfavourable and that living to fight another day in other markets makes more sense for their stakeholders.

New entrants and disruption?

Life offices face increasing competition on several fronts:

- Established D2C players like Hargreaves Lansdown and Fidelity and digital firms like Nutmeg and WealthHorizon will continue to develop and refine the capabilities needed to win the at-retirement segment. Key capabilities include refining customer service, guidance and advice and multimedia marketing as well as data mining and brand promotion.

- Leading investment managers are already building D2C capability which will be deployed in the at-retirement market in competition with traditional providers. Successful though many of these firms are in the US, the UK life offices are strongly positioned to dominate the decumulation market provided they make best use of their assets, ie a bigger group market share, access to retiree data, a broader product palette, and platform ownership.

Facing up to hard decisions will call for strategic honesty

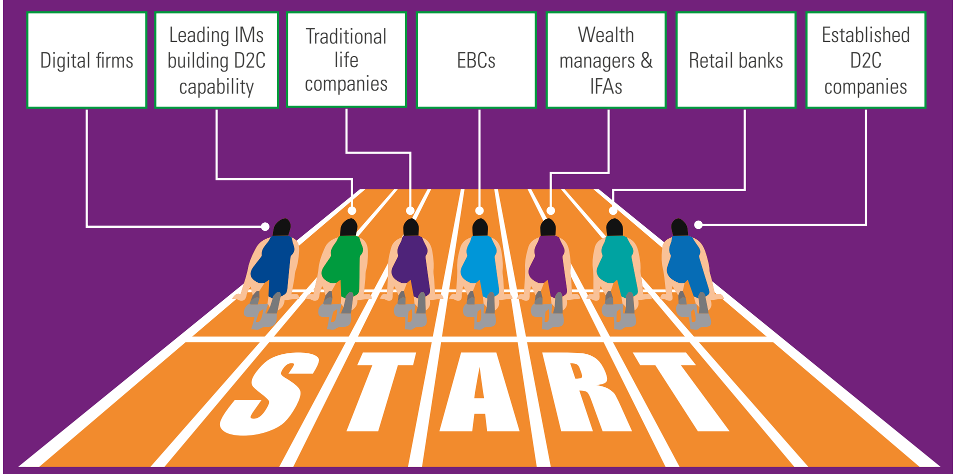
New entrants and potential disruptors will test incumbents' flexibility and resilience

- EBCs, wealth managers and IFAs will also deploy digital platforms to capture share in the retirement market. We expect EBCs to compete strongly in the larger scheme market and IFAs in the SME segment.

- On paper, retail banks have the reach, customer base and omni-channel capabilities to succeed. A favourable FAMR and tax relief outcome could also play to banks' strengths. In the past bridging the gap between potential and reality has proved difficult, leaving banks below natural share in the retirement market.

- There is every reason to expect non-FS brands like Google or Facebook may enter the retail pensions and investment space. The interest digital firms have shown in supporting US wealth management firms, notably the 'robo-advice' sector, will in time be exported to international markets including the UK.

Potential and new entrants



Source: KPMG – illustration purposes only

Back to the future

As with all revolutions, much of what appears to be innovation is in fact re-invention. We expect opportunities resulting from PF and a new guidance regime to bring about a renaissance of some old favourites:

- If the freedoms demonstrated Middle Britain's appetite for guidance and reluctance to pay for conventional regulated advice, FAMR must surely lead to a safer and more practical guided sales regime. We may well welcome back a 21st-century version of 'the man from the Pru' as life offices and perhaps retail banks tap into their customer bases, providing an upgrade to modern platform-based accumulation propositions and access to decumulation guidance. Firms will leverage technology in order to lower delivery costs, so perhaps a more accurate label will be 'the bionic man from the Pru'.

- These reforms may also usher back an updated bancassurance model, enabling banks to 'guide' their army of savers away from the misery of negligible interest rates into new investment options both before and after retirement.

- As in times gone by with the suite of retail stakeholder products that briefly flickered and then disappeared into obscurity, the concept of safe-haven products has its advocates both in the context of general retail savings and retirement income default products. The logic is hard to argue with: give people who don't want guidance or advice a product so simple and safe as not to need advice. The trouble is, on the buy-side, as behavioural finance reveals, much buying behaviour is not governed by logic. And on the sell-side, low risk usually means low or nil real return and market storms tend to penetrate the safest of harbours.

- Workplace did not feature much in the government announcements about PF and choice, which for obvious reasons were focused on individuals. However, an

Some familiar models and propositions from years gone by will reappear but in different guises

Firms will need strategic agility to align rapidly their operating model to the business model

inevitable consequence of the reforms will be renewed recognition of the importance of engaging members at their place of work on the subject of workplace savings. We expect a resurgence of workplace marketing not only in relation to enrolment but, as pots accumulate, to mid-flight communication and then pre-retirement glidepath.

- The death of the annuity will turn out to have been greatly exaggerated. In the guise of re-labelled and repackaged RIFL products, annuities will find their place in future markets. It will be a smaller, more diverse marketplace with narrower margins but still material.

Finally, with the prospect of continued policy instability, agility will be essential but in particular the strategic kind. Operational agility may eventually become a hygiene capability but strategic agility – ie rapid alignment of operating model to business model - will sort the winners from the also-rans.

Faced with a continuous stream of new policies and regulations, pension firms have become better able to implement changes to processes and systems to comply with new rules and regulations. In this way they have been able to stay open for business without necessarily having to change their core business model. However the journey towards operational agility is by no means complete. Many firms have only begun to move customers off complex, legacy products sitting on 1960s IT into simpler, platform-enabled products more suited to the omni-channel, customer centric propositions required in the post-PF world. The cost of transition will be high but not as high as failure to do so.

This time the stakes are higher – a looming perfect storm of policy, regulatory, fiscal and technology-led disruption will impact market structure itself. PF, in conjunction with an accumulation incentive and a guidance regime that work, will be the catalyst that pushes this historically supply-led industry towards becoming more demand-led.

Yes, the emerging customer-centric landscape will hold new opportunities, but also more uncertainty and complexity. Firms will have more options open to them, more strategic choices to make, all with uncertain outcomes. Strategic agility will require from an industry built on actuarial dependability and risk management attributes, a test and learn culture that is unafraid of failure, speed of decision making, speed into market and speed out of market. It will require firms to trust the voice of the customer as much as what the numbers are telling them. Leading firms will work out how to accommodate and incubate counter-cultural ideas from innovators and entrepreneurs whose aim is to disrupt and cannibalise the incumbent model.

This future retirement market is not for the faint-hearted but who knows, in years to come MBA case studies might include a smattering of agile, customer-centric pension firms.

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