Challenges in the Mass-Affluent Decumulation Market

The UK mass-affluent wealth management market is shifting rapidly from the accumulation of assets to their deployment in generating retirement income. This new decumulation market will have very different characteristics to the accumulation market and at Lawrence Somerset we believe that very different business models will be required to succeed in this new environment.

As the mass-affluent move into post-retirement they will need a service from the financial services industry very different from the one they received pre-retirement – they will need a proposition oriented towards total income. This represents a major challenge for an industry dominated by investment thinking and with a focus on products. The mass-affluent have always been more concerned than richer segments with budgeting rather than investment returns. While they were accumulating it didn't matter much that the bulk of the industry was miscommunicating. Now the customers' objective function is total income.

Suppliers will face practical challenges - how to create and deliver an income promotion remotely and at low cost. They also face cultural challenges - how to replace much of their legacy thinking and to become customer-oriented.

The sting in the tail however, is that the new conditions of the decumulation market – a new proposition, an orientation towards customer centricity and a focus on pricing relative to the income produced, not the funds to be managed – is likely to continue if not accelerate the disruptive change introduced by platforms and profitability will move towards those able to master the customer interface.

In this article we set out our view of the challenges, identify some of the winners and losers and point out the necessary components of a new approach.

The Opportunity and the Business Case

The market case for this shift of attention is clear: the Baby Boomers are at their wealthiest and, as many of them are at or are approaching the retirement threshold, their needs are now turning towards regular income.

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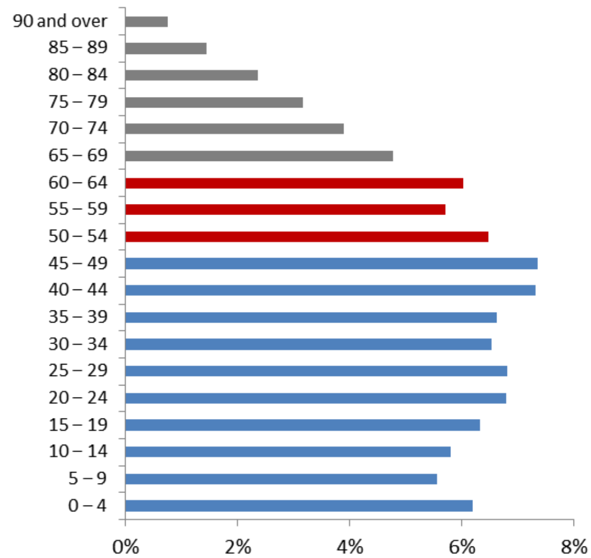
Many Baby Boomers are at or approaching the retirement threshold



UK Population by age
Source: 2011 Census

This demographic trend will be compounded by the fact that increasing number of people will be invested in DC schemes. Towers Perrin have estimated that these trends will mean the £15 billion currently passing from accumulation products each year will grow to £50 billion p.a. in the next 10 years – and this growth could be even greater if DB to DC transfers become popular.

This huge flow of money needs to be turned to income for its owners.

The reason why this market is attracting renewed interest is because two recent regulatory changes have introduced increased uncertainly into what previously has been a relatively predictable process.

- For annuity providers: The Finance Act 2011 removed compulsory annuitisation and introduced new options for drawdown for people who could show that they had, initially £20,000, now £12,000, income in place

- For pension providers: From April 2015, post 55, individuals will be able to access all of their pension pot, subject to tax. So decumulation is threatening what might have been a safe 10-year period at the end of the accumulation period.

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The motivating factor attracting firms' attention is that for some there will be unprecedented outflows, and for others, this is money up-for-grabs that was previously locked down and inaccessible.

The Potential Winners and Losers

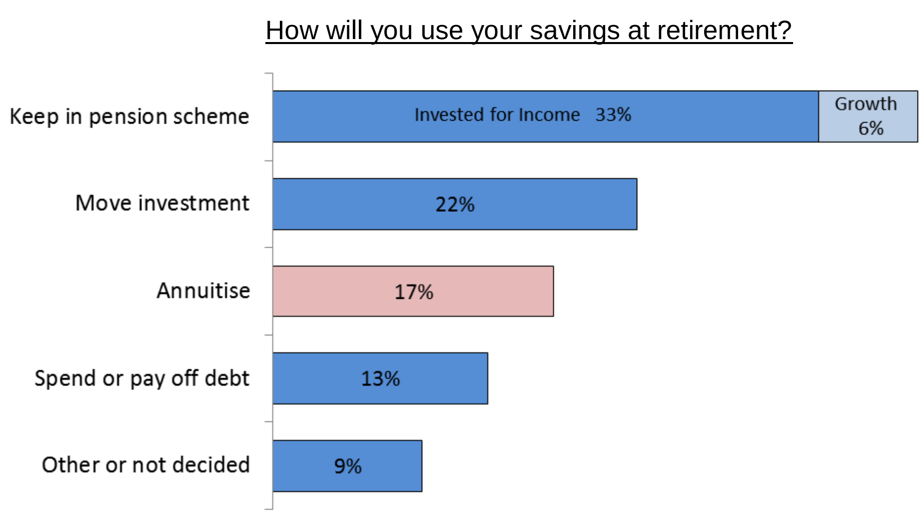
So who might be the potential winners and losers?

The potential losers are in two overlapping camps. The first group are the providers of annuities who have been benefitting from customer lethargy to secure long-term steady cash flows. This will include incumbents in the accumulation markets used to feeding customers into annuities and also the specialist annuity providers who benefitted from the introduction of innovative products over the past decade.

The annuity market has been the first to feel the pinch. Until recently, around 400k annuities were bought each year but between the first quarter of 2013 and the same period in 2014 the number of annuities bought dropped by 48% (42% by value).

Research by Alliance Bernstein suggests that 'at retirement' only 17% of DC investors researched would buy an annuity. There is a clear preference for continued investment, mostly with the original provider but 22% would move and a significant amount of withdrawal for spending or debt clearance.

Only 17% of DC investors intend to buy an annuity at retirement



Source: Opinium, August 2014. Survey of more than 1,000 DC savers. © AllianceBernstein

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Longer term, the Australian market could be a guide as to how low sales could fall to, since annuity purchase is voluntary. There, only 5% of pensioners buy one, so that may be a lower floor.

The second group of potential losers are the ‘incumbents’, the participants in the contractual accumulation business who will see balances decline as some customers take advantage of the early withdrawal option. In a recent survey commissioned by Hargreaves Lansdown, 12% of DC holders in the 55-64 age range said they would take out all their pension monies post April 2015. They estimate this amounts to approximately 200,000 people. The numbers who go for partial withdrawal may be much larger than this.

The potential winners are the non-contractual investment companies that are able to participate in the wall of money that is either emerging from, or which will be withdrawn early from, DC pensions. This group includes all manner of investment provider, SIPP provider, ISA provider, fund platform and life company turned fund manager that currently serve the investment markets. There may also be opportunities for new entrants into the financial markets with trusted brands. For example, it remains to be seen whether the supermarkets are still in this category. Of course, there will be some incumbents who are able to develop customer-oriented strategies to retain funds and perhaps attract additional funds from less able rivals.

These firms will only be winners however if they are able to surmount the formidable challenges in this growing market.

The Challenges

Against this destabilizing context, there are a number of significant challenges that in sum call for a fresh approach to this market that goes beyond extending ‘business as usual’.

This money is already in the system

Many firms may be dreaming of repeating the success had by Hargreaves Lansdown in the period following the “A Day” reforms in 2006. But much of Hargreaves’ success came as a result of being in the right place at the right time. The then Labour government raised the thresholds available to be put into pensions tax-free by an order of magnitude. There was then a flood towards SIPPs. In the five years to June 2009, Moneywise reported that Hargreaves Lansdown saw its SIPP business explode from just £100 million to almost £3 billion.

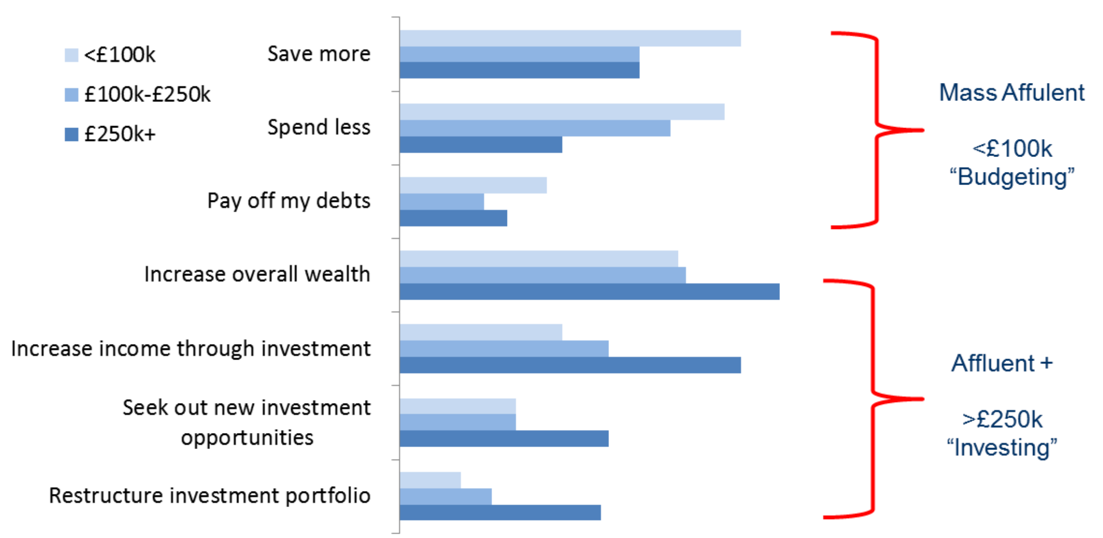
This time, although there does appear to be a huge and increasing potential flow, there are two big differences. First, most of the money is already in the system – in contrast, A-Day attracted new money. Second, there is little incentive being offered to customers to keep it in there.

The mass-affluent are attitudinally different from better off people.

Lawrence Somerset research shows there is a major gulf in attitude between the mass-affluent (with investible assets of less than say, £100k) and those with more funds.

The affluent might be attracted by the rhetoric of an investment proposition even in retirement, in part because it makes sense and they assume they will have plenty of income, but the mass-affluent are more motivated by concepts such as saving more, spending less and paying off debts – all the hallmarks of someone with barely enough to live on and who needs above all to be careful with money. This group are also less interested in increasing their wealth - in contrast to the affluent who are more interested in increasing income through investment, seeking new investment opportunities and restructuring their investment portfolios.

The mass-affluent have very different goals to the affluent



Source: Lawrence Somerset / Mintel data 2012

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This difference in attitude is crucial because the mass-affluent will be less satisfied by a customer proposition based on an investment product and dominated by investment rhetoric.

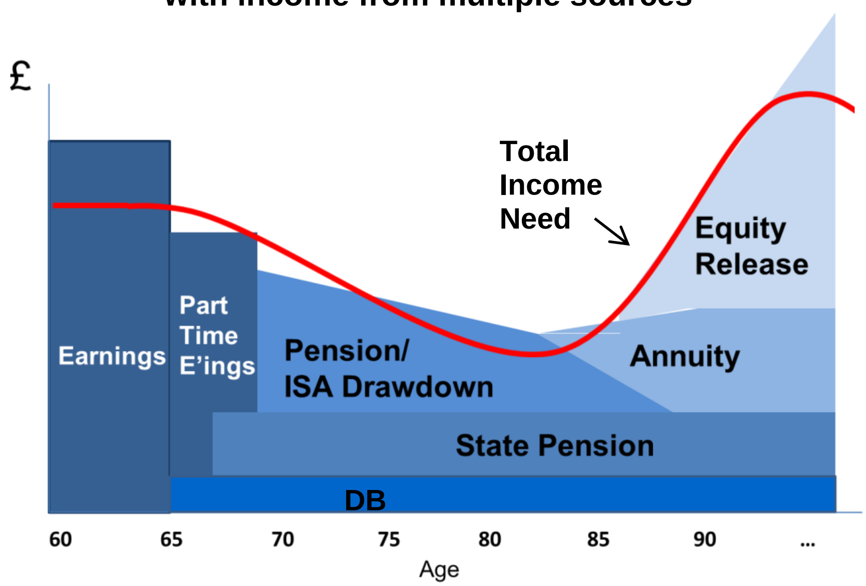
The mass-affluent customer really needs a total income based proposition.

For many decades, the predominant culture of the investment market has been oriented towards investment returns, or in a more elaborate version, a dialogue between returns and risk (with the possible exception of endowments, now defunct, and annuities, no longer obligatory). Furthermore, the dialogue has been oriented towards individual products.

This time, the objective function for the client is total income. This means they will need, somehow, to assess their need for income in retirement, understand each product in terms of its income potential and combine all their possible sources of income together to see if there is a ‘’gap’’.

During retirement, an individual will need to co-ordinate income flows from many sources over a c30 year timeframe. Moreover, both their needs and potential sources will change over the period and the basis of decisions will not be set in stone – for example, decisions about the trade-off between drawdown and annuity will change with age and life expectancy.

People will need to manage requirements with income from multiple sources



Source: Lawrence Somerset

DC investors as a group clearly recognise this need for flexibility - the same Alliance Bernstein survey showed that the vast majority, over three quarters, of respondents with DC schemes wanted flexibility in any solutions offered to them.

Most customers and many providers have not yet got to grips with what such a proposition should be.

The advice market has collapsed.

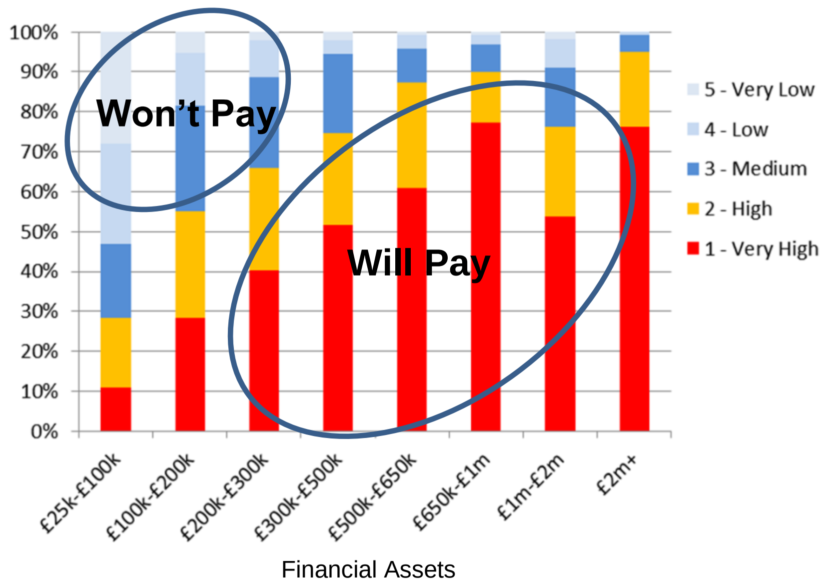
The most obvious source of help for customers wrestling with this problem is the advice market. IFAs who have traditionally directed people to suppliers, are currently in disarray as a result of the Retail Distribution Review, the results of which came into force in 2013.

Between the end of 2011 and the end of 2012, when RDR came into effect the total number of retail investment advisers fell 23 per cent from 40,566 to 31,132. Many of the advisers still in the market did not enjoy the experience with 27% of advisors in a recent survey saying that the last year has been 'the toughest period of their professional life'. Advice will still be available for those that can pay, but the IFAs have now followed the direct salesforces in their withdrawal from the mass-affluent market.

On the demand side, the number of people taking advice on financial decisions fell from 25% in 2008 to 12% in 2013 (perhaps due in part to the recession). And there is a distinct reluctance in the mass-affluent market to take professional advice.

Fundamentally though, this market does not want to pay up-front for advice. As one moves down the wealth spectrum preparedness to pay for advice declines. Sub £100k only 30% are likely to want to pay for advice. This is very relevant when one considers the typical pension / annuity pot of £36,800, i.e. most people will have financial assets very much below £100k

Propensity to seek paid advice declines sharply with declining assets



Source: Experian 2013

One firm has estimated that there will be up to 5 million people in the UK not receiving appropriate advice to support their financial decisions.

The proposed Guidance Guarantee scheme to ensure that free advice is available to those wanting to consider an annuity at retirement is not yet clear and it certainly has not been costed, although there are plans to charge the industry.

Although initially announced as an 'advice' service, it appears the free service will in fact consist of fairly simple 'guidance', with an essentially educative function and is to be delivered by the Citizens Advice Service. One industry observer described it as 'going to a free clinic and being told "you need to see a Doctor"'

There is no real call to action.

The relaxing of the pension and annuity rules means that individuals can defer action for some considerable time. With no catalytic advice, and with no clear stimulus to the market such as the tax incentive offered under the 'A day' regime, it is feared that demand for new investment products will not materialise. Customers will not attend to their future income needs or may default to sub-optimal solutions.

Given the general level of mistrust in financial firms - only 22% of people say they trust banks and financial services companies in the UK according to the 2013 Edelman Trust Barometer - individuals are not likely to be overly active in seeking out the products of companies they do not know.

Firms who want to participate and to draw the mass-affluent away from their default options will therefore need to develop hooks that will speak to real needs and attract customer attention.

The natural conclusion for many suppliers who believe they can do this will be to go directly to customers to promote their services, but this raises new types of challenge:

There is little relationship in place for many firms.

For customers of the incumbents with contractual pensions or savings products, there is seldom any meaningful relationship in place from the perspective of the client. They will likely have spent years receiving statements they could barely understand in complicated language, but not much beyond this.

Perhaps more seriously, these people will have very little expectation of a relationship and so may be somewhat surprised when approached, especially if is done maladroitly.

New entrants are likely to be in a similar position with zero relationship or with a similarly remote contact via fund holdings or perhaps a new worksite marketing proposition which thus far has targeted firms rather than the employees themselves.

Neither group has demonstrated a customer orientation and some still adopt a paternalistic stance towards customers

Creating relationships will be a cultural challenge.

This new market represents a major cultural challenge for many firms that have had little previous interest in being customer-oriented, because relationships were reduced to long term contracts managed through intermediaries. There will clearly be a need to acquire many new skills in segmentation, communicating, branding, proposition development, on-line community engagement etc. in order to develop the necessary hooks to attract attention. More than this, there will be a need to engage with customers, sell to them and hold their attention in ways that they find relevant over extended periods of time and to be ‘present’ and relevant when the decision points are reached.

Bearing in mind that people make decisions somewhat in advance of retirement, the relationship building needs to be done early on, perhaps up to 5 years before retirement, creating the right culture will be especially challenging.

The economics are tight and new business models may be needed.

The funds available in this market average £36,800, with perhaps half of customers having a similar or smaller pot elsewhere. The bulk of people will have far less. This level of funds is fine to support a business model that leads them straight to a compulsory product that locks the funds up until death with little intervention along the way. These funds will not support a traditional cost structure designed to engage with the customer and to sell on the next stage, and certainly not if the next stage is without a contractual basis for funding upfront selling costs. Go direct therefore means go online.

In many ways this is inevitable. The UK leads the world in the use of the internet for researching and purchasing products of all kinds and most financial services business are offering and developing new online services. The challenge is that the bulk of this innovation has been developed from outside the sector by technology firms and most banks, investment managers and life companies are being pulled along rather than driving the change. The risk is that they engage in incremental thinking.

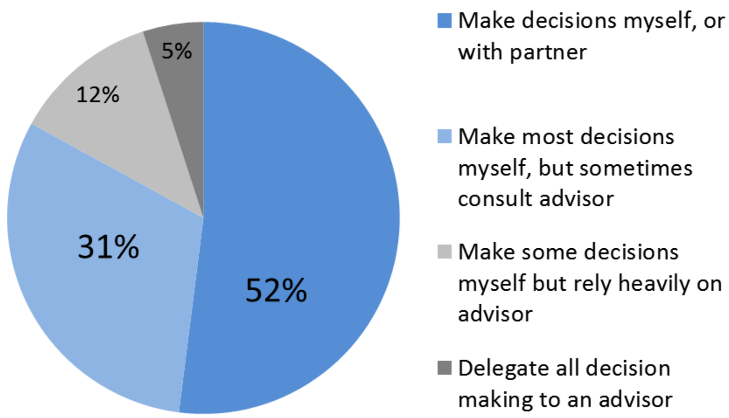
For example, with a new emphasis on income, traditional management fees will come under closer scrutiny. The investment management sector consistently repels any suggestion that there is any alternative to a percentage fee on AUM. With an investment focus and a customer oriented towards returns, a management service costing only c1.5% may look reasonably priced. However, when the customer is seeking income a charge of c20% or more of the potential income rapidly appears very expensive. The conceptual shift needed is to address the question: ***How much is it reasonable to charge to generate a pound of income?***

The fund platforms are currently in the process of disrupting the investment management sector by providing procurement leverage, fund trading is now much cheaper on an independent platform than by going direct, and this process is due to continue. Also, new product forms such as ETFs offer much lower costs, but are not central to many portfolios, - one suspects this is because their charges offer little to intermediaries.

The online emphasis will likely be DIY with facilitation.

It is clear that the central trend in much of the mass/mass-affluent market is towards "DIY". This does not necessarily imply a customer who is fully skilled in what he or she does, but one who prefers to trust their own judgement, or that of family and close contacts, rather than be taken over by an institution. There are a lot of these.

The vast majority of the market appear to take all or most of their financial decisions without professional advice



Base: All those with £50k+
Source: Mintel 2012

This means that to engage such a customer, a firm will need to provide a set of processes that enable the customer to do much of the work themselves. The emphasis for teams of advisers will likely shift from providing advice or guidance to facilitating the use of the tools themselves to support customers' decisions.

Making this type of remote, semi-engaged business model work will be a great challenge for firms used to fire and forget products that earned money in perpetuity, to deploying sales people to sell or refer to more qualified colleagues or to offering discretionary mandates that pass responsibility for action to the manager.

The conceptual shift here is to realise that customers will need facilitation and that the traditional model of intervention in the decision-making itself is not sustainable for such small amounts of money.

Some firms, for example Fidelity, are already well-advanced in this approach, albeit for wealthier or more empowered segments.

There are insufficient online tools available.

The truth is though that there are, as yet, few tools developed that can help customers to operate fully in this way. Lawrence Somerset's own research last year revealed that there are some basic tools: budgeters, cash flow planners exist and that there are many tools for trading either stocks or funds. There are also functionalities being made available for the WRAP platforms by their suppliers, but those tend to have a single product orientation.

As yet, there are few tools which enable the customer, in an integrated manner, to aggregate their assets and liabilities, develop a risk profile, set realistic goals and translate these into financial terms, allocate assets and monitor performance against those goals and identify appropriate action. By integrated we mean two things:

- Existing CRM data and state entitlements can be automatically loaded
- Any data entered into a tool is automatically available to any other tool in the suite.

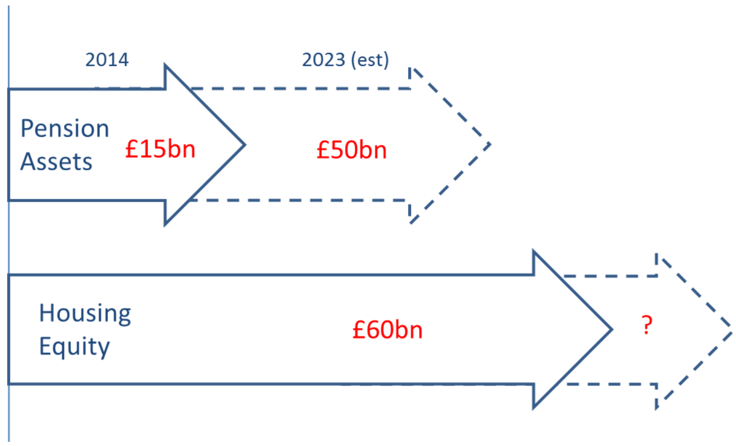
Suppliers are currently collecting together existing tools, developing new ones or looking to platform service providers to help them in a rush to be ready with a new engagement model. However, there is a risk that many of their customers will be put off by overly complex propositions without the proper introduction, which do not function properly, or which simply do not speak to the need for a view of a total income.

The supplier view of the customer's wealth is likely to be incomplete.

Not only will many suppliers not have a full picture of a customer's assets, the largest single part of the picture is not even on their radar. Lawrence Somerset's research has shown that for the mass-affluent, housing equity is their biggest asset and that many mass-affluent are relying heavily on housing equity to supplement some of their need for income in retirement.

We calculate that each year new retirees bring around £60bn of housing equity with them into the retirement market**.**

Annual 'flows' of housing equity exceed those of retirement assets



Source: Towers Watson / Key Retirement Solutions / Lawrence Somerset analysis

This is clearly not as available for income-generation purposes – people need to live somewhere – but it remains the case that the Equity Release market is only scratching the surface of the potential.

The challenge for providers is that typically customers do not share information on housing equity with firms on the asset side of their balance sheet, hindering the ability to provide customers with a holistic view of the income potential.

Conclusion

A short-term fix may seem feasible for many firms, especially for the incumbents currently managing accumulation products. The truth is that many customers are ignorant of their options and will have a tendency to inaction. They may be satisfied by leaving their money where it is or by being offered product extensions that go some way to meeting their needs. This will work in favour of some large incumbents who have large legacy customer bases and a range of investment funds to offer drawdown-like products, but even for these, the reduced flows onto annuities will represent a big shortfall in 'new' funds.

For firms with growing workplace pensions businesses there may some compensatory flows. However we suspect that these businesses are not likely to bring in the funds at first anticipated, that there will be a knock on-reduction in personal pensions contributions and even then at lower margin.

In the longer run though, the challenge for many companies is that the differences in this new market will be so substantial that what is needed is not a modest investment in product development and online services but a radically new business model to serve a different market with different needs and requiring new technologies.

This new business model is likely to reflect the following:

Dimension	Accumulation Model	Decumulation Model
Product / Customer	Product-centric	Customer-centric
Objective Function	Risk / return	Total income potential
Pricing	Pricing based on AUM	Pricing based on income produced
Engagement Model	'Don't wake them' or 'Sell, sell, sell'	Facilitation of customer's process
Contractual Focus	Seek to lock in long-term commitment	Flexible, fungible
Functionality	Expert-driven 'black-box'	Fully automated and integrated to be customer driven
Compliance	Retrofitted compliance at huge cost	MiFiD compliance designed into technology

Our view is that the successful development of the decumulation market could catalyse a further wave of disruptive competition which will amplify the changes already brought about by the incursion of the platform providers.

The situation can be characterised as that of a low-end, low cost proposition that could have very wide appeal, not desired initially by wealthier customers and probably not wanted by traditional suppliers if only because of the margin implications. If successful, the new proposition could be taken up by wealthier customers as a more attractive and cheaper alternative to what is currently on offer.

If this proposition can be created it is therefore most likely to be achieved by new and existing platform providers who have customer service in the front of their minds, can start afresh with new technologies and can plug in the required technical solutions on the basis of delivery and cost considerations. These companies will be starting with fewer preconceptions as to pricing and to the sovereignty of financial skills.

We expect the knock on effect of this will be that many of the traditional suppliers will revert to ‘manufacturer’ status (if they have competitive products) with a parallel focus on the run off of their existing customers which will take some time due to inertia. On this basis the consolidation in the life business is expected to continue and is likely to extend into asset management as high fee structures become untenable.

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Lawrence Somerset is a specialist consultancy offering strategy, customer insight and innovation services to the financial services markets. We have 20 years’ experience of working in Wealth Management markets from the mass-affluent to private banking. If you would like to know more about any of the research or the issues mentioned in this paper, or if you are facing specific challenges in these markets, please call us to discuss.