NEW DYNAMICS IN THE U.K. PENSION MARKET

Product innovation sparked by the abolition of compulsory annuitisation

The changes introduced in the 2014 Budget to retirement plan regulations are the most ambitious in living memory. From age 55, defined contribution (DC) plan members will no longer be obliged by law to have a minimum guaranteed income of £20,000 – from annuity and other sources – from their retirement savings. Instead, they will be free to take their entire pension in one lump sum: with the first 25% being tax free and the rest taxed at the member’s marginal rate. In addition, there will be more choices in retirement planning:

- Those who prefer the security of an annuity will have access to it.
- Those who want greater control over their finances can draw down their savings as they see fit.
- Those who want to remain invested but draw down their portfolio can do so, too.

In sum, around 320,000 people who retire each year with DC pensions will have complete choice over how they access their regular retirement income.

The changes can potentially transform the retirement market over the next several years by diffusing the centre of gravity away from insurance products towards managed funds; from guaranteed income towards non-guaranteed outcomes; from market-beating funds to outcome-oriented funds.

To better understand how the dynamics of the U.K. pension market are likely to evolve we interviewed 15 insurance companies and asset managers. The information gathered from them was bolstered by data gathered in CREATE-Research’s annual surveys for the past two years.

Sweeping Changes to the Retirement Landscape

Retirement planning in the United Kingdom is on the cusp of a major transformation as a result of sweeping changes:

- In his 2014 Budget, the Chancellor of Exchequer announced the end of compulsory annuitisation for members of DC plans in the United Kingdom, effective from April 2015.
- The tax on lump-sum death benefits paid from crystallised funds (a pot from which benefits are already being taken) will be reduced from 55% to the beneficiaries’ marginal tax rate.
- Members of defined benefit (DB) plans will continue to be allowed to switch into DC plans to take advantage of the new more flexible rules, so long as they pay for the required advice when their pots exceed £30,000.

With these changes, the notion of all-or-nothing hitherto inherent in annuities available in DC as well as DB plans has been swept away. This ensured that retirees only had an annuity while they were alive and no unused benefits for bequest purposes in the event of an early death.

Individual savers will now be in the driving seat, bearing the responsibility for managing their savings to ensure they deliver a decent retirement. Retirement risk is now personalised to the individual, raising fresh concerns, such as the quality of advice that will be available to them.
Our research has led us to draw several conclusions about the impact these changes will have on the retirement market:

- **Diversified income funds will gain ascendancy initially, but will not displace annuities, once various risks come to the fore.**
  
  Initial outflows away from annuities will initially favor various diversified income funds, especially those based on passive investments. Over time, however, annuities will make a comeback within a new hierarchy of products, with diversified income funds at the bottom and annuities at the top. In between, two new product sets will emerge: pathway funds that target retirement income in the accumulation phase (e.g., target date funds, diversified growth funds) and managed drawdown funds offering a steady income.

- **Product innovation will involve the reorienting or repackaging of funds.**
  
  The first wave of innovation will see new types of diversified income funds emerge in force. The second will deliver three offerings: phased funds providing a staged approach to annuity; cafeteria plans blending an annuity, income drawdown, life insurance and health insurance; and readapted target date funds.

- **The industry landscape will see competition as much as collaboration.**
  
  Insurance companies will face significant challenges initially, yet will rebound strongly. Asset managers will focus on diversified income funds and pathway funds – sometimes in collaboration with insurance companies, sometimes in competition. And financial advisors will split their fee models and likely focus on the middle and wealthier high-end of the market over time. Pension savers will be perceived as a ‘vulnerable group’ and concerns will need to be met over the quality of advice available – and potential for mis-selling – in the new environment.

**GREATER DIVERSITY IN THE RETIREMENT LANDSCAPE**

Although the end of compulsory annuitisation will affect the supremacy of the insurance annuity as the ideal retirement product in the United Kingdom, they still offer benefits for many retirees. After an initial decline, we expect annuities to find a place in the new, broader hierarchy.

Research done by CREATE-Research shows that the U.K. annuity market attracted annual inflows of around £12 billion until 2014. We anticipate that around £8 billion of these annual inflows will migrate to other forms of investments, including rented properties, in the short term.

We expect those holding pot sizes less than £15,000 will most likely cash out completely. But those whose balances are higher will likely migrate towards investment products in the immediate aftermath of the end of compulsion. Our research indicates that the emerging hierarchy of products will comprise a variety of offerings, ranging from annuities at the top and low-cost diversified income funds at the bottom (see Exhibit 1).

Initially, the end of compulsion will favor diversified income funds, which blend equities and bonds via passive funds, active funds, standalone single strategy funds, multi-asset class pre-packaged funds, or total return funds targeting capital growth and high dividends. However, over time, we expect greater diversity in the product offering, with annuities prevailing alongside other options.

**LIKELY SCENARIO FOR THE UNITED KINGDOM**

Each pension system is an intricate web of history, geography and culture. So while the experience of Australia and the United States is revealing, it is perhaps unwise to simply project the U.K. outlook on what has happened there (see “Learning From Australia and the United States” on page 3). However, their experience served to provide practical reference points in our interviews as we sought to identify the nature of funds that are likely to do well in the United Kingdom, both in the short- and medium-term.
Such reference points are essential: no widely accepted product nomenclature exists for investment funds. Their descriptions overlap a lot between suppliers. For example, diversified income funds (in Exhibit 1 on page 4) can be passive, yet be part of multi-asset class funds. Likewise, active funds can have standalone strategies, yet be part of total return funds. Through our interviews, we identified five key areas of change likely to result from the elimination of mandatory annuitisation in the United Kingdom:

1. Diversified income funds are likely to emerge as the immediate beneficiaries of the new rules.
2. As the impact of fees on retirement plan balances becomes more decisive, exchange traded funds (ETFs) are likely to benefit.
3. The influx of money from DB plan participants migrating to DC funds will encourage the development of new funds.
4. The competitive dynamics between insurance companies and asset managers will shift, settling into one of three likely scenarios.
5. Advisors will see their role shift, and the market likely will evolve into a split model with embedded advice common for lower-balance funds, and more customised advice available to those with higher savings.

Immediate Impact: The Rise of Diversified Income Funds

Product choices ultimately will be influenced by product features, as well as the personal status of retirees. Diversified income funds (see Exhibit 1) are likely to emerge as the immediate beneficiary of the new rules allowing DB plan members to switch to DC plans. Overall, these funds will aim to deliver one or more of four benefits:

- Regular income
- Low volatility
- Capital growth
- Inflation protection

Each of these goals aims to address the additional risks decumulation portfolios have to bear: sequence of returns risk (linked to the time taken for a portfolio to recover after a market collapse); longevity risk, the risk that the participant will outlive his or her assets; and inflation risk (when rising prices erode returns).

Learning From Australia and the United States

Australia and the United States are the two largest DC markets in the world. Both countries have pension regimes similar to what has been proposed for the United Kingdom. Their experience can provide some insight into what the future may hold in the United Kingdom. While its pension regime currently offers plan participants flexibility, Australia faces growing demand for compulsory annuitisation. Rising longevity coupled with low plan balances mean 81% of current retirees rely on the state to supplement their private savings. Diversified income funds dominate in the decumulation phase, and most plans have an equity component of at least 50%, due partly to equities’ favourable tax treatment for retirees and partly to help increase the pot size.

Although retirees in the United States also face increasing longevity and insufficient plan balances, such worries are more muted. In the absence of compulsory annuitisation in the United States, the range of retirement funds is wide, with well-developed advice channels for different pot sizes.

Annual annuity spending in 2012 amounted to US$7.7 billion. Those with low balances tend to favour diversified income funds as shown in Exhibit 1. Also popular are:

- A bucketed approach, under which the retirement pot is invested partly in guaranteed sources of income (like annuities) to cover essential day to day expenses, and partly in an investment portfolio to cover discretionary expenses.
- Pathway funds, such as target date funds, which hold nearly US$700 billion currently. On approaching retirement, the asset allocation glide path is re-set to deliver regular income to take plan participants ‘through’ their retirement.
- Managed drawdown funds, which can be set up to provide a percentage of principal, ranging from 4% to 7%, to the retiree each year; or to set the drawdown in absolute money terms, aiming to liquidate the investment over a specified period, typically 10, 20 or 30 years; or to provide a payout based on a predetermined lower and upper limit, depending on realised investment returns.
Some of these funds will be repackaged versions of old-style balanced funds with bigger exposure to bonds, to generate regular income. These will function basically as a one-stop option for investors who don’t want to wade through pages of research. Other funds will use call options to minimise the volatility of the underlying equity investments that may give rise to the sequence of returns risk.

Funds aiming to address capital growth risk will adopt a broader basket of assets, such as high yield bonds, global value securities, commercial mortgage-based securities and emerging market debt, to enhance returns.

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Some funds will use real estate investment trusts (REITs) and infrastructure investments to provide inflation protection, although for the foreseeable future inflation is unlikely to rank high on their agenda.

"Initially, annuities will be hit hard. They will soon revive, though, and prevail alongside investment products in an ever diverse retirement landscape.”

– Interview participant
While identifying these possibilities, however, our respondents were at pains to point out two issues:

1. In the post 2014 Budget environment, ensuring that suitable levels of widespread retirement planning takes place promises to be a significant 'Everest' of a task owing to the prevailing low levels of financial literacy in the country. It is one thing personalising the risk through the abolition of compulsory annuities, and quite another to deliver acceptable results. Most likely, those retirees who have low plan balances or are less financially confident will seek low cost commoditised diversified income funds served by the platform market.

2. The choice of retirement funds will also be influenced by the value of the retiree’s non-pension assets, such as family home, rented property and social security entitlements. Over time, as their health and family circumstances crystallise, retirees may also contemplate equity release products to bolster their retirement incomes. Before then, many retirees – especially those with sizeable pension pots – will also seek to secure regular income via property investments.

**Focus on Fees and Charges Will Increase Use of ETFs**

The second key point to emerge from our interviews concerns the rising importance of costs. In the near term, we expect that passive funds will be favoured over active funds. At a time when interest rates are likely to remain low, at least for the next three years, few diversified income funds will be able to deliver the 5% to 7% target (net of fees) set by retirees for annual income.

Once compounded, lower fees will be seen as a key source of outperformance. Fee compression will become the norm, further promoting the rise of passive funds. The main beneficiary will be ETFs, because of their ability to 'slice and dice' the investment universe to meet diverse investor needs. Exhibit 2 shows how ETFs are deployed as an allocation tool in the retirement space in the United States. They blend a diverse range of strategies.

Indeed plans are afoot to create ETFs based on lifestyle risk – with distinct tilts towards healthcare, life sciences, fuel and care homes – that replicate the average basket of goods and services retirees consume. This has the potential to turn ETFs into an advice-embedded product, too.

**Exhibit 2: A stylised allocation in a retirement product based on ETFs**

![Exhibit 2: A stylised allocation in a retirement product based on ETFs](image-url)

Source: CREATE-Research 2015
Transition From DB to DC Plans Will Encourage Innovation

The third area our industry experts felt would have the most impact on the retirement plan landscape is the shift by employees from DB to DC plans. Both the initial 25% tax-free allowance and the reduction of tax on the lump-sum death benefits are seen as highly attractive ‘carrots’ to make this change. We expect the switch from DB to DC will accelerate over the next five years, from a slow start.

As a result of this migration, the amount of privately managed money in the decumulation is set to grow both as a result of both the organic growth of DC plans and the switch from DB plans. Here we can draw on the experience of the United States, where annuitisation via a DB plan is no longer the first choice and lump-sum distributions are on the rise.

In 2013, of DB plan members who had a choice between annuitisation and lump sum distributions, approximately 40% choose to annuitise. For those who had cash balance plans, only 20% opted for an annuity. Recently, in some plans, members opting for lump sum distributions have increased to 75%.

This shift reflects a desire on the part of plan members to balance the longevity risk with investment risk. It may be that members are poorly informed regarding their remaining life expectancies. But there are some rational forces at work, too:

- Some retirees have strong bequest aspirations: they worry about potential losses to heirs if they die early, since annuitisation eliminates the possibility of a refund on unused expected benefits.
- Some retirees worry about having to pay for long-term healthcare: a longer life does not mean a healthier life.
- Some retirees worry about locking their savings into current low yields in annuities as an irreversible decision.
- Some retirees see charges on annuities being too high compared to indexed funds owing to loads levied by many providers.
- Some retirees see lump sum distribution as especially attractive because regulations allow them to take relatively large sums, computed on the basis of a prevailing low discount rate. For retirees, this is about the only benefit from today’s zero-bound interest rates.

However, insurers are aware of these concerns and are creating annuities with guaranteed returns after a period as well as other options. Some insurers are now seeking to offer a blended offering: mixing annuity with healthcare, life insurance and disability benefits to allay the fear of losing it all in the event of premature death.

In 2014, total pension assets in United Kingdom equalled roughly £2.2 trillion, of which £1.6 trillion was in DB plans (72%) and £0.6 trillion was in DC plans (28%). Over the rest of this decade, as much as 15% of ‘mature’ DB assets are likely to switch to DC plans, bringing in additional £240 billion in search of retirement funds, according to our interviews.

Depending upon individual plan balances, at least half of these new funds are likely to adopt the bucketed approach evident in the United States. In particular, managed drawdown funds and annuities will benefit just as much as diversified income funds.

With the new wall of money, investors will look for diversity, rather than low-cost commoditised options. Thus, while the outlook for annuities and managed drawdown funds will be less favourable at the outset, their prospects should improve over time, as DB money seeps into the DC space.

“The migration of DB money into DC space will be a tipping point, at which the retirement market will shed its one-size-fits-all image.”

- Interview participant
New Dynamic Between Asset Managers and Insurance Companies

As the emphasis shifts from delivering guaranteed incomes via annuities to delivering a multiplicity of outcomes via managed funds, the competitive landscape for insurance companies and asset managers will change.

Insurance companies relying heavily on annuity products are likely to be ‘losers’ over the next three years or so, until the influx of money arrives from the DB space. However, most insurers are unlikely to suffer significantly, since they already have a lineup of diversified income funds in place via their own in-house asset management subsidiaries. Besides, asset managers have yet to develop capabilities outside diversified income funds and pathway funds.

Via their distribution arms, such subsidiaries also manage a large chunk of accumulation funds in the DC space and ‘own’ the client relationship. Thus, when these funds mature, these insurance companies are well placed to roll over their accumulated portfolios into decumulation funds. Many insurance companies will thus seek to retain the maturing assets into their own product offerings.

Having dominated the retirement markets in the past, insurers will aim to extend their footprint in every segment of the hierarchy described in Exhibit 1 – on the back of strong brands which they have created.

On their part, asset managers are likely to benefit in the short-term via growth in diversified income funds. Currently, they have an edge over insurers in this segment – especially in areas like passive funds, multi-asset class funds and total return funds. Indeed, once the reforms are implemented in 2015, the central thrust of asset managers’ efforts will be directed at establishing a pole position in these three areas.

For product providers, therefore, we see three potential scenarios for the next five years.

- **Peaceful co-existence**: In this scenario, insurance companies and asset managers will deepen their existing niches and both benefit from the reforms – insurance companies at the top half of the hierarchy in Exhibit 1 and asset managers in the bottom half.

- **Head-to-head competition**: In this scenario, insurance companies will increasingly venture into asset management space to retain their share of the wallet, whilst asset managers venture into managed drawdown funds to strengthen their hold on retirement money.

- **Collaboration**: This scenario envisages the arrival of ever more hybrid products which combine the best features of guaranteed products and managed funds. This is already evident in pathway funds.

Our research shows that the second and third scenarios are more likely than the first. Retirement income funds likely will evolve rapidly into a scale game dominated by large players with the necessary IT platforms and record keeping capabilities, if the U.S. experience is any guide.

Advisors’ Role Will Split

Financial advisors also will see a large shift in their roles with these changes. Financial advisors likely will be in demand initially because 80% of retirement asset holders have never managed more than £15,000. Over time, however, advisors will be attracted towards providing holistic solutions, as the new generation of products increasingly embed advice, permitting investors to buy them on the web. The cost of advice will go up, and revenue models likely will be polarised:

- At the commoditised end of the market, the bulk of diversified income funds will either embed advice in their offering or rely on passive funds. Indeed, it is conceivable that, over time, digital advice engines will emerge to offer guidance and education on a scale that will diminish the role of financial advisors for this portion of the market, as has happened in the United States. Fee compression will be the norm.

- At the opposite, value-added end of the scale, advisors will have significant influence – especially among retirees with pension pot sizes in excess of £100,000. As a result, financial advisors’ roles will extend beyond fund investing and include other sources of wealth and income, as well as estate planning.
Annuities brought a degree of certainty. They entailed a single decision, akin to buying a house. Investment funds will, on the other hand, entail new decisions forced by episodic changes in family, health or market situations. As a result, the nature of advice will change.

With personalisation of risk, retirees will be increasingly seen as a vulnerable group. Unless advisors up the ante in terms of the quality of their advice, they will be exposed to all manner of reputation risk as well as litigation. The current advice infrastructure will need extensive upgrading, if retirees are to generate savings as their pots deplete over time.

The 2013-enacted Retail Distribution Review (RDR), which aimed to introduce more transparency and fairness in the investment industry, has driven out mediocrity in the Independent Financial Advisor market and raised the average quality of advice. Arguably though, in some cases, it falls short of what is required or is too expensive in others for a ‘normal’ retiree.

DEVELOPING INNOVATIVE RETIREMENT PRODUCTS

It is one thing empowering retirees to make choices that are in their best interest; quite another ensuring that their decisions deliver acceptable retirement outcomes. Hence, the most ubiquitous question now being asked is, “What is the best retirement product?” The simple answer is: there isn’t one on the market – yet.

Managing money in the decumulation phase is a lot harder than in the accumulation phase. Generic solutions like ‘save more, spend less, work longer’ are few and far between in decumulation, and personal circumstances can vary greatly.

In an ideal world, a retirement solution would:

- **Provide a guaranteed income** whilst having the potential to boost the retirement pot, especially when the markets surge.
- **Allow on-demand withdrawals** to help retirees meet their changing needs.
- **Ensure retirees don’t outlive** their savings.

In the wake of the reforms, product innovation is likely to accelerate. Our research identified three innovations that hold special promise:

1. **Phased funds**
2. **Cafeteria plans**
3. **Re-adapted target-date funds**

We expect these emerging products will prevail alongside fixed and variable annuities. Because while traditional annuities do not provide the flexibility for many retirees to achieve goals such as bequests and long-term healthcare, insurers will offer blended offerings, mixing annuities with healthcare, life insurance and disability benefits.
Phased Funds Aim for Seamless Transition
First available in Canada, phased funds are still at a nascent stage in the U.K. market. They aim to provide a seamless journey from work into retirement using diversified income funds. These are then effectively rolled over into annuities when the retiree decides to do so.

The traditional annuity model makes three assumptions about retirement; that retirees have:

- **Financial security** and the ability to pay day-to-day living expenses.
- **Personal independence** that goes with self-care, family support and state support.
- **Personal choice** about where to live, what to eat and what hobbies to pursue.

In reality, this is not the case for the large majority of retirees, thanks to rising life expectancy. The 'bridge' offered by the diversified income funds gives flexibility as to when to buy an annuity, as the retiree’s personal circumstances – like health, housing and other needs – crystallise over time. This, in turn, will help retirees make more informed choices about their decumulation plans.

Pick and Mix Elements Within a Cafeteria Plan
With a cafeteria plan, retirees can pick and mix elements to create a blended solution that meets their needs. This basket of options, some of which are negatively correlated so that their total cost can be less than the sum of the parts (e.g., annuity and life insurance), might include:

- **Annuity income**
- **Drawdown portfolio**
- **Insurance coverage**
- **Spousal benefit**
- **Residual wealth transfer**

This approach is based on providing options to meet unforeseen needs in the age of longevity. Hence, the plan envisages part of the retirement pot invested in an annuity to provide regular income and a longevity hedge. Alongside the annuity, the plan covers the purchase of life and health cover, if required. The rest of the pot remains invested in assets generating income and some capital growth. This invested portion can be structured to deliver regular drawdowns to augment the annuity income, if necessary.

Insurance companies are currently considering this type of a 'blended' solution as an improvement to the existing annuity structure. A cafeteria plan seems to offer retirees an alternative insurance-based arrangement that addresses the three features of annuities retirees dislike most (their expense, their all or nothing nature and their zero balances for bequests) while also providing an opportunity to grow the retirement pot even after retirement.

Finally, cafeteria plans offer a cost effective means of enjoying insurance-oriented retirement benefits thanks to the scale economies insurance companies enjoy in their delivery.

“Over time, we expect to see hybrid products that aim to mimic the features of an ideal retirement product.”
- Interview participant
Re-Adapted Target Date Funds Focus on Liability Matching

Target date funds have emerged as one of the top investment innovations of the last decade, holding approximately £60 billion of assets currently in the United Kingdom. We expect that target date funds will morph into a best-in-class retirement product via two routes over time (see Exhibit 4 on page 11) — hybrid target date funds and target income funds. With these products, the ‘to’ and ‘through’ retirement phases will increasingly overlap:

1. **Hybrid target date funds** will replace traditional fixed income allocation in the glide path with a pool of unallocated deferred annuities. Typically starting at 3% at the outset, the annuity income allocation will build up to 55% by the target date. Hybrid target date funds aim to start targeting a retirement income benchmark in the accumulation phase, and to adopt an appropriate asset allocation to reach that target, following the model used by DB plans. To do this will require collaboration between asset managers and insurance companies.

2. **Target income funds** will adopt an explicit retirement income benchmark — typically, the percentage of current income needed in retirement to maintain the current standard of living. Some funds may go even further and express retirement outcomes in terms of regular income, inflation protection, healthcare and bequests.

These new variants of target date funds will shift the focus from asset maximisation to liability matching. The underlying investment strategy will have two goals: desired income and the minimisation of risk in achieving it. The latter will be secured by allocating a sufficient portion of an investor’s assets (plus future contributions) to an index-linked fixed income portfolio that is duration-matched as much as possible. The remaining assets will be managed to improve the estimated probability of achieving the desired income goals — a portion of which will be dedicated to achieving outperformance. After achieving the predetermined estimated probability, assets will be gradually shifted from equities to fixed income.

“*A modified version of life cycle funds – with income focus – may well be the best retirement product.*”

- Interview participant
This liability-driven investment-light approach is one way in which the target income approach will seek to mimic the best features of today’s DB plans. They will not require plan members to make investment choices, nor expect them to be engaged or possess a high degree of financial literacy.

**A NEW AGE IS DAWNING: WILL YOU COME OUT AHEAD?**

The measures outlined in the 2014 Budget mark the dawn of a new age for the U.K. pension industry. As with any new age, we will see both winners and losers. Over the next three years, we expect that asset managers will see new inflows, while insurance companies take a hit on their annuity business. Financial advisors will also benefit greatly from these changes.

The new dynamic unleashed by the reforms will vastly enhance the diversity of the retirement market.

- Annuities will feature alongside other investment products. Insurers will strike back on the back of their formidable retail brands.
- Fee pressures will force financial advisors to migrate to the ‘high end’ market, leaving digital advice search engines to serve the lower end.
- The influx of money migrating from DB to DC plans will encourage innovation, with phased funds, cafeteria plans and re-adapted target-date funds showing the most promise.

However, with the personalisation of risk, the scope for improper selling will abound. To counter that, the retirement industry will remain under a regulatory spotlight. Thus, in the final analysis, the real winners will be those who develop a fiduciary heritage that puts clients first, sells what their clients need (rather than what they have), avoids unrealistic claims about returns, seeks a deeper understanding of clients’ goals, and has a fee structure that offers value for money.
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If you would like to learn more about what our research has shown about our outlook for the retirement industry in the United Kingdom, or if we can help you and your organisation meet the challenges ahead, please contact your relationship manager or usual Northern Trust contact, or visit www.northerntrust.com.

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