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UK life insurance futures
Growing the retirement opportunity

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Introduction

Life insurers are rethinking their strategies, business and operating models. They face a prolonged period of unprecedented market dislocation which they cannot afford to ignore. Auto-enrolment, the Retail Distribution Review (RDR), pension freedom, the ageing population and consumers' preference for leaving their pensions invested, rather than buying an annuity, will dramatically reshape profit pools over the next ten years. In addition, the industry has become more vulnerable to disruption. Disruptors are targeting long-standing areas of market weakness, such as the perceived high cost of advice, as well as new opportunities, such as high demand for flexible retirement income created by pension freedom.

The consensus view among market commentators is that asset managers, not life insurers, will emerge as the main beneficiaries of dislocation in the retirement market. Deloitte believes that while asset managers will indeed benefit, life insurers are also well positioned to grow. They have important advantages over asset managers and banks. For example, a dominant position in workplace pensions gives life insurers access to many more corporate, as well as individual, pension customers than other players; deep actuarial expertise gives them a key to winning bulk annuities. However, success will depend on developing new skills and taking more risk – either by expanding rapidly into growing lines of business, or accepting more insurance or investment risk on the balance sheet.

This paper examines the major trends reshaping the market. It introduces our view of the options life insurers have to take advantage of market-shaping trends.

Profit pool composition to shift dramatically

UK life insurance profit pools are set for an unprecedented shift (see Figure 1).

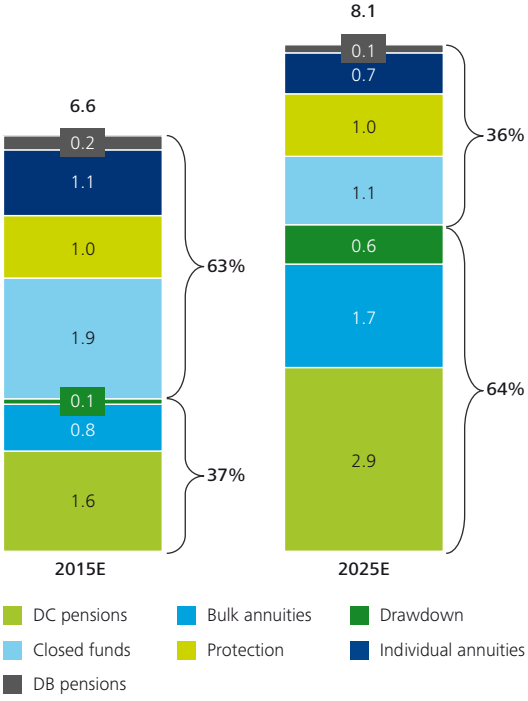
Auto-enrolment (AE) will spur growth in defined contribution (DC) pensions. It will nudge up to 9 million people into saving more, or for the first time, in a workplace pension.[2] As a result, annual contributions will increase by £9-12 billion by 2018.[3] Population ageing will also boost DC pensions. The average saver will be older and, as a result, richer in 2025 than today. The mean age in the UK is projected to increase from 40.4 to 41.6, giving the average saver an extra year of contributions and asset growth.[4]

Pension freedom will grow drawdown, at the expense of annuities, because it has given the 320,000 or so people who retire each year with a DC pot the freedom to leave their funds invested rather than buy annuities.[5] Many retirees are taking this option: in Q2 2015, sales of drawdown surpassed annuities for the first time.[6] This will lower profitability as annuities are much more profitable than drawdown. There will also be leakage from the system as some people are using pension freedom to withdraw more cash upon retirement – to pay down debt or spend - than the 25 per cent tax free lump that was typical before pension freedom.[7]

By contrast the ageing population will lead to growth in bulk annuities. Corporates will continue buying bulk annuities to mitigate the risk of providing pensions to former employees who live longer than expected. Demand for bulk annuities is likely to increase when interest rates rise because higher rates will reduce scheme deficits and make bulk annuities more affordable.

We estimate that defined contribution pensions, bulk annuities and drawdown will become almost twice as important, accounting for more than 60 per cent of profits, by 2025.

Figure 1. Estimated profits, £ billion



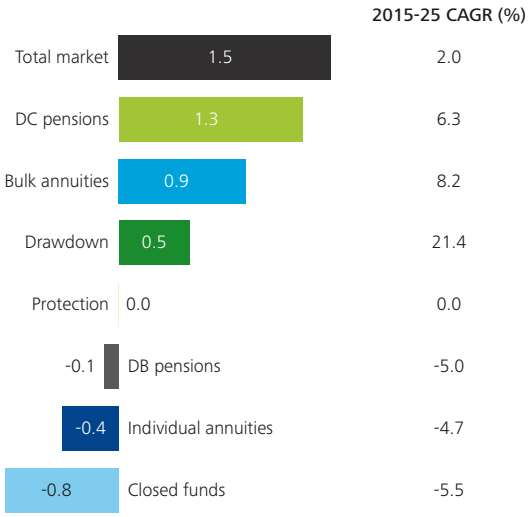
Source: Deloitte analysis[1]

We estimate that £3 billion, or approximately 40 per cent, of 2025 profits will be derived from new business written over the next ten years, almost all of which will come from DC pensions, bulk annuities and drawdown.

Consumer attitudes will cause the protection market to stagnate. The current level of demand is likely to hold up because many customers feel compelled to buy protection with a mortgage to protect their dependents; in some cases, the mortgage loan is conditional on taking out protection. However, sales of protection without a mortgage slowed in the late 2000s and are likely to remain weak without major innovation that improves the appeal of the product.[8] Protection has been tarnished by its association with often mis-sold Payment Protection Insurance (PPI).[9]

As a result of the trends discussed above, we estimate that total market profits will grow by £1.5 billion from 2015 to 2025, with DC pensions, bulk annuities and drawdown outpacing the market in aggregate (see Figure 2).

Figure 2. Estimated absolute profit growth 2025 vs. 2015, £ billion



Source: Deloitte analysis

Disruption threatens

Life insurers face the twin threat of falling margins and loss of share in DC pensions and drawdown as low-cost international asset managers bring their successful business models to the UK. The new arrivals have already entered the accumulation market, targeting mass-market customers who have joined workplace pensions due to Auto-enrolment. For example, NOW: Pensions, a Danish pension provider, entered the DC market in 2010. It has an annual management charge of 30 basis points, around 20 basis points lower than a competitive benchmark.[10 11] International powerhouses in retail asset management, such as BlackRock, have entered the drawdown market.[12] Looking back over the past twenty years, the US market illustrates the extent to which asset managers can squeeze life insurers out of a retirement market where annuitisation is optional. We estimate life insurers now manage only around ten per cent of total US retirement assets, mainly in annuities, while asset managers dominate.[13]

Deloitte recently carried out an extensive research project with the World Economic Forum (WEF) on innovation in financial services. It found that "incumbent players are most likely to be attacked where the greatest sources of customer friction meet the largest profit pools."[14] In other words, the location of disruption is predictable because it tends to happen where incumbent players earn large profits and customer dissatisfaction is high.

The advice market is also vulnerable to disruptive innovation – either by incumbent life insurers or new entrants. According to Citizens Advice, there is widespread demand for more affordable financial advice: the charity found that only one in 50 would pay more than £1,000 for advice on (taking a flexible income from) a pension pot worth £61,000 against a current average cost of £1,490.[15 16] Many customers cannot afford advice because their pension pots are too small. Likewise incumbents appear vulnerable to disruption by innovative new entrants offering simpler and more engaging ways to save for retirement. There is an obvious need among customers for simpler products that are easier to understand. Few people think pensions are straightforward (6 per cent), easy to understand (4 per cent) or engaging (2 per cent), according to the National Employment Savings Trust.[17]

The WEF research found that "innovations are having the greatest impact where they employ business models that are platform-based."[18] Platform-based innovations have great potential to disrupt markets because they are highly efficient, connecting existing buyers and sellers, rather than creating new markets. Platform-based innovation is disrupting the reinsurance market: catastrophic risks are increasingly passed on to capital markets via securities, rather than being reinsured, which is depressing reinsurance prices and profitability. There is potential for similar disruption in life insurance from platforms that pass longevity, mortality and morbidity risks to capital markets.

We estimate that if life insurers do not respond to threats of disruption they could lose up to a quarter of profits by 2025 to asset managers, banks and other new entrants. In this scenario life insurers' total profits would fall by approximately £1 billion compared to today.

We believe life insurers can compete effectively with other market participants because they have important advantages.

Winners and losers

The consensus view among commentators is that asset managers and banks, not life insurers, will be the main beneficiaries of the market dislocation discussed above. In particular, asset managers are seen as likely winners of pension freedom because customers will opt for their retirement income products, rather than annuities. Deloitte's view is different: we believe life insurers can compete effectively with other market participants because they have important advantages.

Leverage strong ties to employers to continue dominating the DC pension market. Life insurers have strong ties to employers because they provide most corporate pension products. In contrast, asset managers supply funds within those products and as a result are less familiar to employers and employees. However, to maintain their dominant position in DC pensions, life insurers will need to enhance their investment and marketing capabilities for retail customers. The following four components are important because they help customers make crucial savings and investment decisions:

1. Investment propositions that cover a full range of customer life stages and provide low-cost solutions with specific, pre-determined objectives.
2. Customer brand, marketing and engagement that focuses on pension savers in early and mid-life who are least engaged, using digital channels to apply engagement techniques based on insight from behavioural economics.
3. Insight into customer life-stages, based on analysing customer spending and saving patterns using advanced analytics, e.g. for segmentation of company workforces.
4. Online platforms for workplace savers, providing a single portal from which customers can access all their pensions and other savings in one place, adapting best practices from online banking.

Exploit actuarial expertise and risk management skills to manage mortality, longevity and investment risk.

Three distinct opportunities exist:

1. Removing or capping risk in pension schemes for corporates.
2. Insuring against the risk of running out of funds, e.g. due to expensive medical care for pensioners in later life.
3. Managing health and financial risks in a more integrated manner for people of all ages.

A degree of re-risking will be required by life insurers to convert their advantages in actuarial and risk management expertise into market success. Life insurers will have to pivot against the trend of recent years for de-risking balance sheets in anticipation of Solvency II and to smooth earnings.

The most successful will exploit a strong understanding of where maximum value can be created compared to capital required, and where risk should be laid off to minimise risk concentration.

Alternatively, **insurers can innovate their business models**, adopting a similar approach to the industry outsiders that are likely to target the obvious market weaknesses discussed above. Although the life insurance industry has a mixed track record on innovation, we see the following two opportunities for life insurers to stand out by developing different, or better, propositions than those of their peers:

Provide customers with affordable help to take financial decisions. Low-cost advice, guidance and financial education are clear opportunities to provide customers with affordable help making financial decisions. They fit well within a low-cost direct-to-consumer platform that allows customers to execute their decisions. Automated advice models (robo-advice) can generate low-cost yet well-researched, personal product recommendations for a saver with typical, i.e. simple, needs. Life insurers can collaborate with employers to provide affordable high-quality advice in the workplace, e.g. seminars and guidance based on automated advice models. They can help consumers by educating them on financial matters more effectively than today. Materials that are more fun and engaging, such as videos, are a good place to start. Incumbent life insurers are in a strong position to develop more affordable advice and guidance for consumers. They have more widely recognised brands, better market knowledge and stronger balance sheets with which to experiment than potential disruptors.

Refashion life insurance using digital technology. Subject to regulatory and ethical considerations, life insurers have an opportunity to make protection more popular by providing it through connected devices, such as smartphones, smartwatches or fitness bands. This mode of delivery has four obvious benefits. Customers could be rewarded in real time for healthy behaviour tracked by connected devices with lower premiums. Cover could be adjusted remotely at the point of need, e.g. when playing sport or embarking on holiday. Information could be provided to customers on how to manage health and lifestyle risks via devices. The customer interface could be made highly engaging, for example by a partner expert in digital customer engagement. Research suggests that protection provided in this way could have widespread popularity: 42 per cent of health insurance customers aged 25-34 surveyed would like a technology service that helps detect health problems and provides assistance.[19]

Insurers can innovate their business models, adopting a similar approach to the industry outsiders that are likely to target the obvious market weaknesses discussed above.

Response levers to market disruption

Develop a clear strategy on which profit pools to target. Many insurers do incremental strategic planning intended to improve positions within the markets they play in. Profit pools are set to change dramatically. This shift will necessitate more than incremental planning. Those in lines of business with a positive outlook, such as retirement, will need to increase their efforts to maintain positions, let alone improve them. For business with negative or neutral growth prospects, life insurers would benefit from deciding whether to exit or be the 'last man standing'. In addition, those that now evaluate the extent to which they will be affected by disruption can take moves to pre-empt it: they can protect their position or become a disruptor themselves. To guide their strategies, incumbents can take a view on which types of disruptors are most threatening. To what extent do big technology brands pose a threat, or does the real danger lie in Silicon Valley type start-ups?

We estimate that life insurers would need to generate cost savings of just under £1 billion by 2025, representing approximately 10 per cent of 2014 expenses, to maintain profitability at current levels.

Decide the role of M&A in repositioning. For some, disposal of non-core assets can be an important way to raise capital or reduce the cost of legacy business; for others, disposals can provide an exit from unsustainable competitive positions. Acquisitions can be the fastest and most cost-effective way to gain capabilities to serve growing markets. As a result, joint ventures will probably increase in importance, especially in areas subject to disruption where Fintech companies offer both the technology and the new ways of thinking required for innovation.

Digitise as much as possible. Due to a slowly expanding profit pool, falling margins and digitally enabled new entrants, insurers that move quickly to a digital-led operating model can be more effective in protecting market share and profitability than digital laggards. Those that capitalise on digital technology, such as social media, wearables and the Cloud, are likely to be best placed to defend their business. Digital technology can also be used to develop new propositions, such as investment ideas based on crowdsourcing, protection linked to wearables data and peer-to-peer insurance.

Use the power of data. Insurers that exploit their rich data and strong analytical skills can personalise their products and services: the notion of a customer segment of one is becoming a reality. Improving the ease with which data can be accessed, its quality, governance and security is critical, in addition to developing insightful analytics. To date, large volumes of data have been fragmented or locked up in hard to access systems.

Update the operating model. Updating operating models based on the skills required for the new pension landscape – such as retail investment and marketing for pensions, and risk management for bulk annuities – will be an important lever for success. Deciding whether to carve out new standalone businesses is a key decision. They can be optimal structures given the challenge of complex changes required by the market. Management of closed funds will be vital to minimise cost and maximise cash flow given their large size. We estimate that closed funds will account for more than ten per cent of total profits by 2025 (see Figure 1).

Institutionalise innovation. Developing the forum, mind-set and ways of working to foster innovation will likely separate market leaders from the pack. This is because, as Deloitte's research with the WEF indicates, "disruption will not be a one-time event, rather a continuous pressure to innovate".[20] Incumbents which develop a strategy for interacting with Fintechs that fits their organisational characteristics, ranging from incubators to indirect investment, are likely to enjoy the most successful innovation programmes.

UK life insurance profit pools are set to be dramatically reshaped over the next ten years. For life insurers, there are major opportunities in the retirement market and bulk annuities, while disruptive threats lurk around new advice models and alternative sources of capital. Collectively if insurers get this right they can both defend profitability related to business on the books and access the additional £1.5 billion in profits that will emerge over the next ten years. However, if they fail to respond, then competitors will increasingly side-line insurers, leaving them to face the bleak prospect of competing for a profit pool that is £1 billion smaller than today. Success is dependent on acting now – to re-evaluate strategy, business models and M&A before investing aggressively behind a selected path. Those that fail to act with sufficient speed and force will succumb to disruption and suffer long-term decline.

Those that fail to act with sufficient speed and force will succumb to disruption and suffer long-term decline.

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