Deloitte.

Funding our future
Meeting the long-term savings challenge

Contents

Foreword

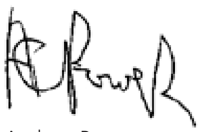
Investment management is a growth industry. Rising wealth, population growth and constraints on government spending all point towards the industry attracting more assets.

Through a series of reports under the umbrella title of *Funding our future*, Deloitte seeks to engage the industry, policymakers and regulators in discussing the role the investment management industry can, and should, play in both managing the nation's savings and financing the long-term investments that are vital for supporting a growing economy and population. Too often the financial services industry has been criticised for its short-termism and focus on narrow measures of success. Through these reports we will explore how the industry can continue to enjoy profitable growth while at the same time contributing to the public good. We want to help foster a sense of collaboration between the industry, the policymakers and the investor.

This report discusses the impact of demographics on the investment management industry. It looks at how a growing population, with greater life expectancy, creates substantial new assets to manage but also magnifies the problem of the long-term savings gap. We discuss the nature of the challenge, the hurdles to overcome, and the implications for the investment management industry. We do not seek to be prescriptive, but offer ideas to stimulate debate and create momentum for change.

We hope you enjoy this report and look forward to lively discussion, with both the industry and with a wider group of stakeholders, about the opportunities and challenges that demographics and other long-term trends have for the investment management industry.

Mark Ward



Andrew Power

Executive summary

In spite of the challenges brought on by changing regulation, the pace of innovation, and the growing demand for low-cost products and services, the investment management industry stands to benefit from the long-term opportunity presented by population growth in the UK.

By 2050, the UK population is projected to grow by almost 20%, to 77 million, as a result of continued net immigration and increasing life expectancy. By contrast, the populations in Germany, Italy, and the Netherlands are projected to decline.

The UK population growth will provide a welcome boost to the assets available to investment managers, although, in time, it will be offset to some extent by the growing number of so-called decumulators (those aged over 65), a cohort that will peak between 2035 and 2040. A larger and older society will also create a tremendous opportunity for the industry to invest in infrastructure, housing, health and long-term care needs. These trends are often presented as challenges, but we believe that if they are addressed head on, industry, government, and policymakers working in collaboration can provide a stimulus to the economy and a welcome boost to overall wealth levels in the UK.

The focus of this report, the first in Deloitte's *Funding our future* series, is on the UK long-term savings challenge and the role of the investment management industry and policy-makers in responding to the opportunities presented by population growth, longevity and continuing market reform.

Substantial market reforms have already been implemented by the UK government over the past five years, driven by a desire to lessen the dependence of an ageing population on the public purse. The industry has been presented with sweeping changes in the way that people accumulate and draw down long-term savings.

Government action to increase the state pension age and introduce auto-enrolment has been helpful in addressing the retirement savings gap. However, Deloitte expects the annual savings gap per person to increase between 2015 and 2050 from £8,000 to £10,000. For the entire working population, this means that the annual long-term savings gap is set to increase from £250 billion to about £350 billion.

This change will be driven by:

- a growing population;
- the further decline of defined benefit (DB) pension schemes; and
- increasing income needs during retirement due to the rising cost of health care and long-term care.

The government has made substantial reforms in recent years and will continue to tackle the fiscal deficit. While further tax incentives are unlikely, future policy levers exist around non-tax incentives, continued emphasis on education and awareness, and stimulating innovation for the investment management industry.

The investment management industry has an important role to play and stands to benefit from helping people address their long-term savings needs. We estimate, that after taking into account the available housing wealth and non-pension specific savings like ISAs, the industry can close up to 50% of the remaining long-term savings gap. This would be driven by growing the number of people contributing to long-term savings, increasing the average contributions for those people saving, and improving net returns.

To achieve this a number of hurdles must be overcome. We have identified the following four as critical:

- Human nature and low levels of financial awareness get in the way of decision making.
- The long-term savings market is fragmented, comprising many different providers and products.
- Investors require better value-for-money services.
- Solutions need to be tailored to increasingly diverse personal circumstances and preferences.

While government and policymakers can take steps to incentivise the right behaviour, and create the right market context, the investment management industry has a clear role to play. We suggest four specific solutions that the industry can adopt:

- Improve consumer communication, engagement and guidance through digital tools.
- Support information aggregation, to help overcome the fragmented nature of the industry.
- Lower costs of operations, products and services through technology enablement.
- Create more flexible products and services that are better tailored to individual needs and circumstances.

To adopt these solutions and win the long-term savings challenge, the investment management industry will need to be more agile and responsive. The task is substantial, but can be accomplished by those industry participants that are willing to invest in new skills in the areas of technology, product management and marketing and communication.

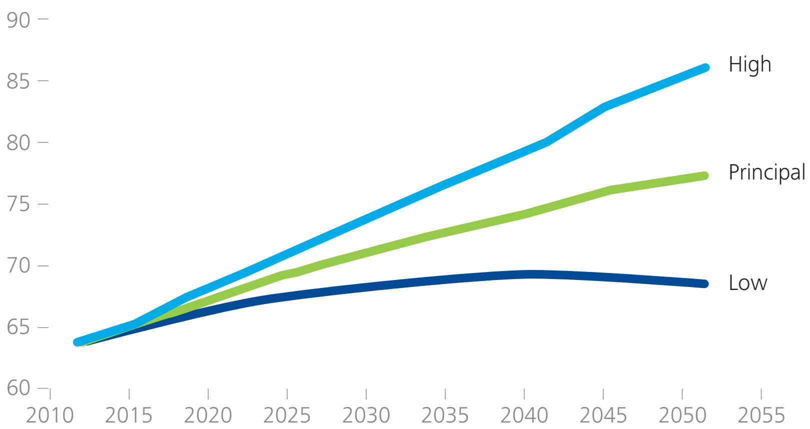
The investment management industry has an important role to play and stands to benefit from helping people address their long-term savings needs.

The long-term savings challenge

The size of the investment management industry is determined largely by demographic shifts, economic growth and the amount of wealth generated in society. Demographic shifts happen slowly, but over time have a profound effect on the national economy, available wealth and the demand for long-term savings solutions.

The principal projections by the Office for National Statistics (ONS) for the size of the UK population point to a 19% growth over the next 35 years, taking the number of people in the country from 65 million today to 77 million in 2050 (see Figure 1).[1]

Figure 1. UK population growth scenarios (millions)



Source: ONS, 2013

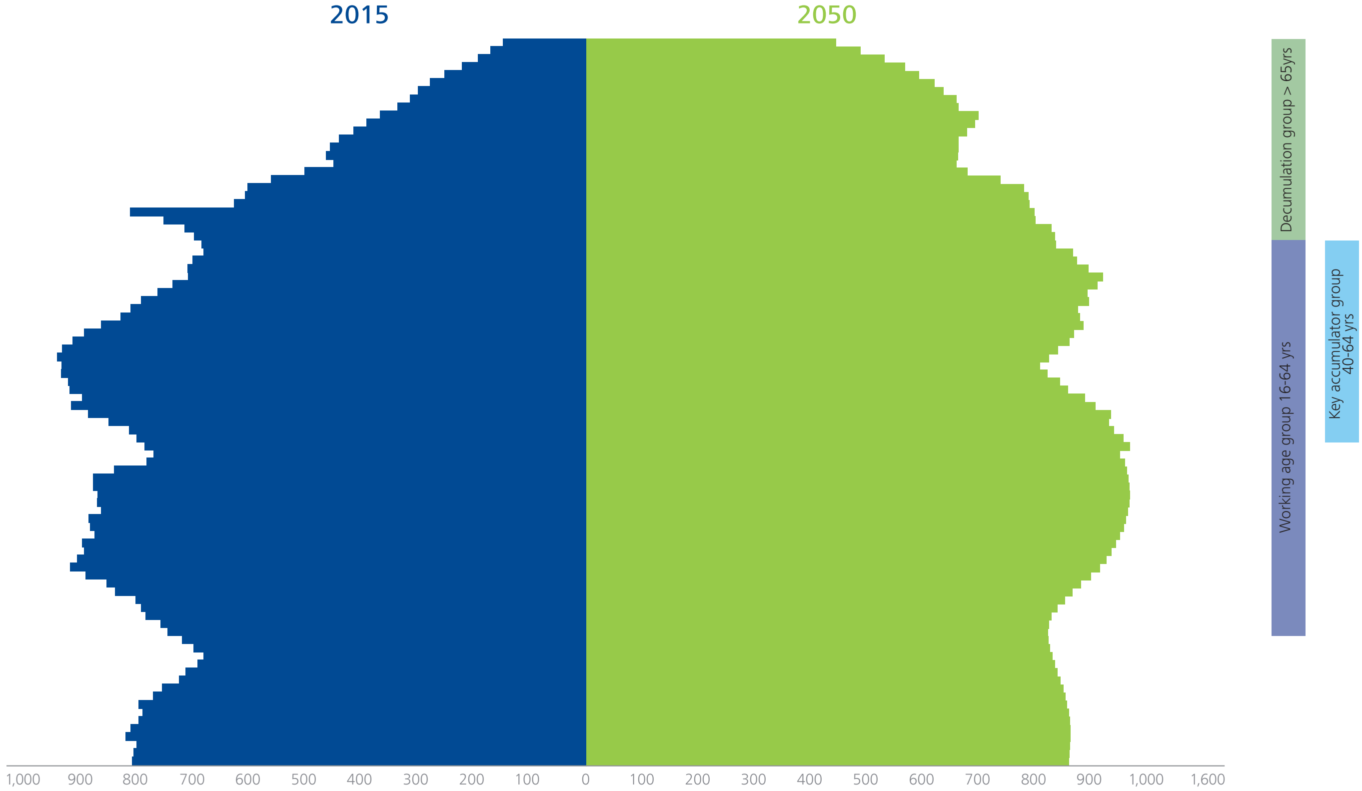
The lowest projection points to a 6% increase, or four million additional people, by 2050, with the population reaching a plateau in 2035, and reducing thereafter. Given the historical trend in birth rates, life expectancy and net immigration, this outcome seems highly unlikely. Increasing life expectancy is set to continue, with the average life span forecast to increase by 2030 by more than five years for men and four years for women (to 86 for men and 87 for women).[2]

In view of the strong population growth that can be expected, the UK needs to plan for increased demands on its infrastructure, health care system, and housing. For the investment management industry, this presents a significant long-term opportunity that senior executives in the industry should be thinking about today.

However, population growth will not be evenly distributed. By 2050 there will be almost eight million more people aged over 65 (a rise from 12 million in 2015 to 20 million in 2050), while the number of working age people between 16 and 64 is expected to increase by just three million, to 44 million. More people will be renting their home, as many will have found it impossible to buy. Continuing net immigration means ever-increasing population diversity.

For the investment management industry, this presents a long-term opportunity that senior executives in the industry should be thinking about today.

Figure 2. UK population pyramid 2015 and 2050 (thousands)



Source: ONS, 2013

Averages of wealth and income mask differences in the distribution of both: some people will see only a small drop in income after retirement, while others will face a substantial cut and may have little wealth to cushion the blow.

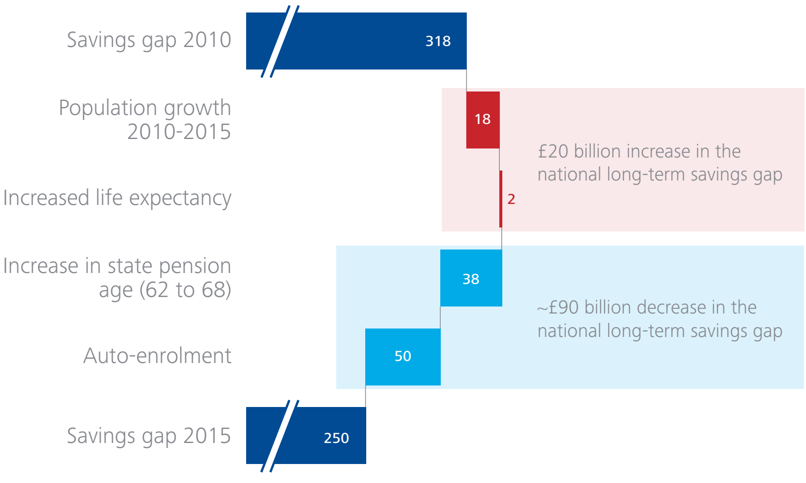
These shifts in the make-up of the population will change the dynamics of the investment management industry. By 2050, the UK population will be much older, with 25% of people in the phase of savings decumulation, compared to 18% today (see Figure 2). While growth itself will present a significant business opportunity, successful firms that are willing to adapt and respond to the changes in society will benefit even more.

The retirement savings gap today

It is widely understood that people in the UK have a retirement savings gap, and are not saving enough today to afford a reasonable standard of living in retirement.[3] In 2010 Deloitte, estimated this gap to be £318 billion, or the equivalent of £10,000 per year for each person retiring between 2011 and 2051.[4]

In the five years since, much has changed: auto-enrolment ensuring that nearly all workers will be enrolled into a pension scheme; a state pension age that is due to rise to 68, and could rise further[5]; a bigger population, and increased life expectancy. In addition there have been significant changes in the level of the State Pension, private pensions and tax-advantaged Individual Savings Account (ISA) allowances, and also the new policy of pensions 'freedom' that gives people more flexibility in how to use their pension savings in retirement. While this flexibility and greater customer choice is welcome, it does not answer the question of whether people will have enough funds to provide for a decent income in retirement.

Figure 3. Annual long-term savings challenge 2010 – 2015 (£ billion)



Source: Deloitte analysis, 2015

Revisiting the assumptions underlying our previous work, we find that the annual long-term savings gap for the UK has fallen from £318 billion in 2010 to £250 billion today (see Figure 3 below). A slightly larger population and improved life expectancy over the past five years mean that, in aggregate, £20 billion of additional savings are required annually. However, this is more than offset by the increase in the State Pension age and the introduction of auto-enrolment, which combine to reduce the gap by almost £90 billion annually for those retiring between 2016 and 2056.

Impact of government reform

On the current agreed timetable, the pensionable age for men and women will be harmonised at 65 by 2018. After that, the pensionable age will rise for both men and women, to 66 by 2020 and 67 by 2028, and is expected to be 68 by the mid-2030s, under the principle that future generations should spend approximately one-third of their adult life in retirement.[6] As people are expected to work longer the amount of long-term savings will increase. Our analysis suggests that this shaves £38 billion off the retirement savings gap (see Figure 3).

The Department for Work and Pensions (DWP) expects that auto-enrolment will halve the number of people retiring with no private pension at all, from 27% today to 12% in 2050.[7] As auto-enrolment will increase the participation rate in occupational pension schemes, we estimate that an additional seven million people will start saving automatically for retirement over the coming decades. This will reduce the annual long-term savings gap by £50 billion.

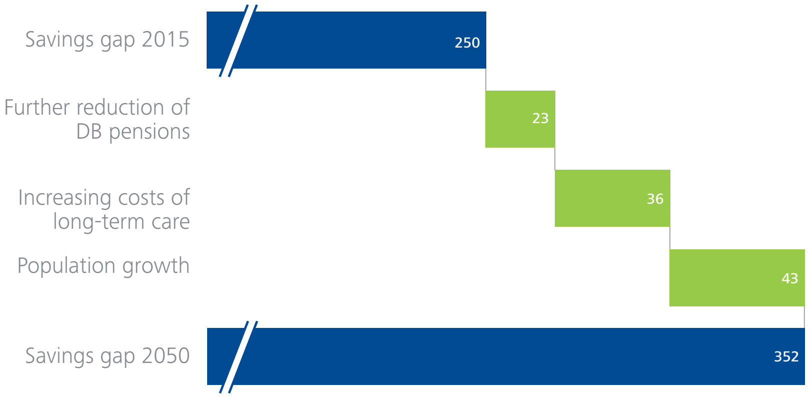
Future headwinds increasing the long-term savings gap

Despite the benefits of auto-enrolment and the increases in the State Pension age, the long-term savings challenge is expected to grow over the coming years, for three reasons (see Figure 4):

- DB pension schemes will continue to decline.
- The population will continue to grow.
- People will need more savings to cover the increasing cost of health care and long-term care.

When interest rates rise, this will alter the income and valuation of long-term savings. Given the uncertainty of the timing and size of these impacts, and of their combined effect, we have not modelled this explicitly.

Figure 4. Future headwinds (£ billion)



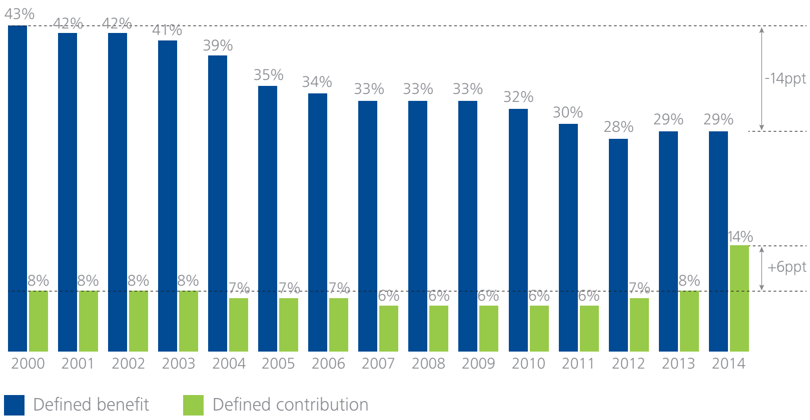
Source: Deloitte analysis, 2015

The continuing decline of DB pension schemes

The decline in DB pension schemes continues. As Figure 5 indicates, the percentage of employees participating in DB schemes has fallen by 14 percentage points since 2000. Over the same period, participation in defined contribution (DC) schemes has increased by 6 percentage points, but this has only happened since the introduction of auto-enrolment in October 2012.

With the continuing decline of DB schemes, and the average contribution rates to DC pension schemes less than half the contribution rates to DB schemes (9.1% versus 20.6% of salary respectively[8]), total contributions for participants have fallen substantially in recent years. Additional voluntary contributions (AVCs) are required to provide for an adequate retirement income. As the State Pension and Occupational Pension combined will cover only a 45% replacement rate,[9] roughly one-third of retirement incomes will need to come from additional contributions in order to reach a 70% replacement rate.[10] This is the level that is seen by the OECD as an adequate level of income in retirement for the average person.[11]

Figure 5. Proportion of employees with DB and DC pension



Source: ONS

Many DB schemes have closed because several factors combined to make them less appealing to employer sponsors: increasing life expectancy; persistent low interest rates that increased scheme liabilities; and accounting changes that forced companies to recognise shortfalls in funding arrangements.

87% of all private sector DB schemes have closed to new members or future accruals, and there are now just 810,000 active members.[12] Many of these schemes are looking to sell their closed books to insurance companies.

In line with projections from the DWP, we have assumed a fall in the DB participation rate of about 14 percentage points over the next 25 years.[13] This would mean a reduction of about five million people benefiting from the higher and guaranteed benefits in DB schemes. In financial terms, this equates to an increase of £23 billion annually in the retirement savings gap.

The increasing cost of long-term care

The total costs of health care and long-term care will increase due to the growing population and the longer average time we spend in old age. Projections by the Office for Budget Responsibility (2012) point to a spending increase of around three percentage points of GDP over the next 45 years (from 7.9% today to 11.1%).[14] It is unclear as yet who will pay for this increase, but the cost will ultimately fall on the UK population, either through higher taxes or as some form of individual contributions.

Our calculations suggest that each person, on average, would require an extra £1,250 annually in retirement to cover the rising costs of long-term care. This is the equivalent of a 3 percentage point rise in the replacement rate and translates into an increase of £36 billion in the annual long-term savings gap.

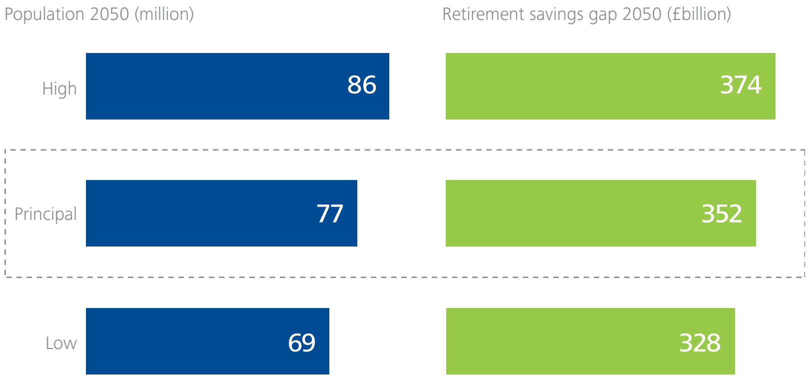
Continued population growth and longevity

Net immigration and increasing life expectancy are the drivers of UK population growth, while birth rates are expected to be relatively stable over time. With increasing attention to healthy lifestyles and continued advances in medical science, life expectancy is expected to increase further. While the amount of net immigration is dependent on government actions, recent history has shown that curtailing immigration is not easy and with ongoing population growth elsewhere in the world it is likely that immigration will continue to be a net contributor to UK population growth in the future.

Taking the ONS's principal projection of population growth, our analysis suggests that about four million additional working people will need to save for retirement. This equates to an increase in the annual retirement savings gap by £43 billion to £352 billion. Should the ONS's highest population projection come to bear, the annual long-term savings gap for the UK could grow to £374 billion.

Figure 6. Population growth sensitivity

ONS population growth scenarios (Low, Principal, High) all suggest significant increase in pension gap over the coming years



Source: ONS, Deloitte analysis, 2015

It will not be easy to overcome the long-term savings challenge; nevertheless it presents a big opportunity for the industry.

Overcoming the hurdles

Behaviour biases and low levels of financial literacy	Inertia, present bias and low levels of financial literacy militate against people making adequate provision for their retirement
Market fragmentation	People accumulate multiple pension 'pots', meaning they may not realise how much they have saved; that their assest allocation is sub-optimal and that the fees may be higher than they think
The need to provide value-for-money	Increased regulatory scrutiny, higher levels of competition, and changes in client demand require lower fess and charges and improved returns
Growing demand for flexible and tailored solutions	Unique and changing personal circumstances and preferences and the increased choice emerging from 'pensions freedom' mean that the 'right' solution will vary widely from person to person

Overcoming the long-term savings challenge calls for government, policymakers and the industry to work together. Although recent government reforms have reduced the savings gap substantially, there remains a significant long-term gap from an ageing and growing population alongside lower average employer pension contributions. We believe the investment management industry can embrace the opportunity, using innovations to encourage more saving. For this to happen, future government reforms to savings regulation must recognise the potential of the investment management industry to innovate and develop solutions.

The role of government policy

The UK government has introduced a number of major policy reforms in recent years that have significantly changed the savings environment. The impact of major reforms such as increasing the retirement age and the introduction of auto-enrolment has been positive for savings. However, the complexity of the savings and investment management landscape means that any reforms, now or in future, should be considered terms of their overall impact on savings.

In view of the scale of reforms already undertaken, the likelihood of any further major system overhaul, such as a compulsory retirement system similar to Australia and Singapore, seems unlikely. That said, the consultation about pension tax relief launched in the July 2015 budget, suggests that the government is considering substantial changes to the structure, timing and amount of tax incentives for retirement savings. Due to the rising costs of tax relief, the government is unlikely to increase the tax incentives for retirement savings.

We consider that further government action should focus on three areas:

- Increasing non-tax incentives for individuals to save.
- Greater education to create greater awareness of savings products.
- Stimulating innovation in the investment management industry.

The introduction of auto-enrolment will bring about a big change in savings behaviour. By October 2018 the minimum contribution will be 8% of earnings. This will be a substantial increase in long-term savings, but for many, this increase will not be sufficient. Additional savings incentives are likely to be required. The government may need to consider some form of auto-escalation, such as the Save More Tomorrow scheme in the US, in which contributions increase as employee pay increases. Australia also has introduced changes to bring about a gradual increase in the contribution rate from 9% in 2013 to 12% in 2019. Any such changes in incentives will need to be considered balancing the effectiveness of tax incentives in promoting savings against the cost to the state in tax relief.

Government can also play an important role in creating greater awareness of savings products, through education. The concept of a 'pension passport', which is currently being trialled by the industry in conjunction with government, would be a good first step. Having the relevant pension information on a single page in clear and simple language should be a great benefit for consumers.

Such initiatives can also help to stimulate innovation within the investment management industry, and there is a facilitating role for government in such developments. For example, greater standardisation and digital provision of data would enable providers to give consumers a consolidated view of their entire retirement savings. Access to a holistic view of an individual's entire savings would remove a significant barrier in today's system and benefit both consumers as well as industry participants.

Most importantly, government must ensure that, whatever policy reforms are introduced in future, there is room for the investment management industry to innovate in response to consumer demand and ultimately allow consumers greater control over their own long-term savings.

While the government continues to have a role in addressing the savings gap, more can be done by the investment management industry. Our research found four specific hurdles that must be overcome to increase the aggregate level of long-term savings in the UK.

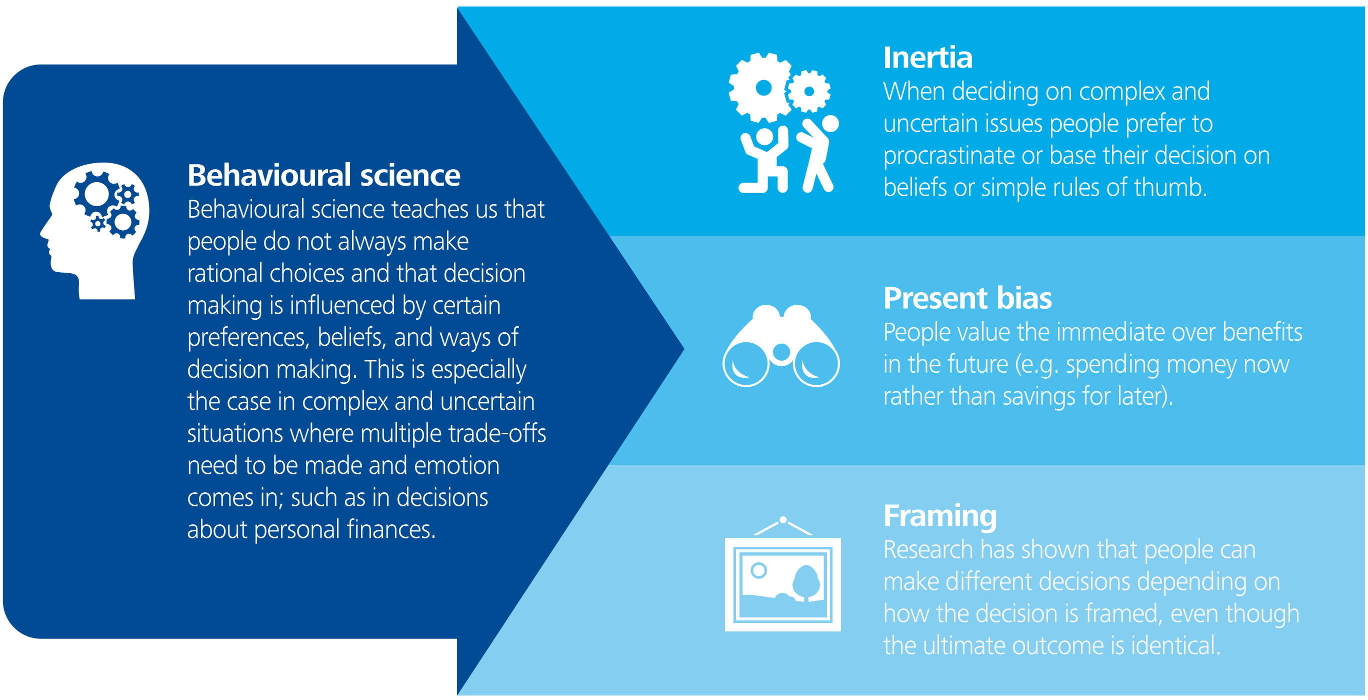
Behavioural biases and low levels of financial literacy

The most important barrier to closing the gap is that human nature gets in the way when it comes to planning for retirement. Besides the fact that financial services and retirement planning is generally of low interest in people's lives, there are specific behaviours that come into play when people deal with long-term decision making that are very relevant when thinking about solutions to the growing retirement challenge (see Figure 7).

Complex decisions under uncertainty

Planning for income in retirement is complicated and fraught with uncertainty. In a 2012 survey by the DWP on attitudes to pensions, 63% of respondents agreed that "pensions seem so complicated that I cannot really understand the best thing to do".[15] It is now well established, through behavioural science, that people by nature are not very good at dealing with complexity. Faced with uncertainty, they will resort to procrastination, using simple rules of thumb, and make decisions on the basis of perception or beliefs rather than rational logic. While uncertainty cannot be avoided, transparency can reduce complexity, and flexibility of choice helps mitigate uncertain life events.

Figure 7. Behavioural science



Source: Deloitte research

Bias towards the present

Another lesson from behavioural science is that people value the immediate over benefits in the future. This trait prevents many people from making rational decisions (or any decisions) about providing for their future. Auto-enrolment tries to deal with this by ensuring that people who would not otherwise participate in a pension scheme contribute without having to make an active decision. This could also be the reason behind the relative popularity of Individual Savings Accounts (ISAs) over personal pensions, as people prefer the flexibility and accessibility of ISAs over locking up money in a personal pension that cannot be taken out until the age of 55.

The challenge for the investment management industry is to motivate people to save beyond what is automatically provided for by the State Pension and Occupational Pensions.

Framing

A third behavioural trait affecting saving for retirement is that people make different decisions depending how the decision is framed. Research has shown, for instance, that savings contributions in occupational pensions vary substantially depending on whether the choice was presented as 'salary deductions' or as 'supplementing employer contributions'.[16]

Research commissioned by the Financial Conduct Authority (FCA) into framing in the context of annuities has also shown that using the term 'annuity' changes people's choice and perception of the product. In one specific trial, product preference fell by 16 percentage points (from 66% to 50%) when the word 'annuity' was mentioned, all other things being equal.[17]

Understanding the influence of framing on decision-making for long-term savings can help service providers improve communication to consumers: several firms already conduct research, and have taken initiatives to adopt lessons about framing in their communications and dealings with customers. It is also encouraging to know that the FCA is currently working with industry to find better solutions on how to frame or present information for standardised pension statements.[18]

Low levels of financial literacy and awareness

In addition to the behavioural biases that get in the way, the degree of financial literacy and awareness also plays a part. Many people in today's workforce have been brought up believing that the State Pension and rights built up during their working life are enough for a good retirement. They may not realise those retiring today often have the benefit of guaranteed DB pay-outs, as well as other sources of wealth, such as housing equity. Given the demise of DB schemes and the increasing numbers of people in rented accommodation, these sources of wealth are less likely to be available to people retiring in 20 to 30 years' time.

The government has made important steps towards improving financial literacy and awareness among both children and adults. It has introduced financial education into the national curriculum, and the Pensions Wise helpline will help inform adults. Meanwhile, standardised pension information statements[19] will remove some of the confusion and complexity around pensions. The industry, too, has a role to play in making its communications with customers clear, simple and engaging.

Market fragmentation

The UK long-term savings market is fragmented, with about 6,000 company-linked DB schemes and a rapidly-growing number of DC schemes. Outside occupational pensions, options that are available to save individually for long-term needs include Self-Invested Personal Pensions (SIPPs) and Individual Savings Accounts (ISAs). In addition to the wide range of 'products' and tax 'wrappers', there is also variety of providers, from private insurance companies and investment managers to pension funds run by Trustees, and government-sponsored entities such as National Savings & Investment (NS&I) and NEST.

As a result, the size of individual schemes and fund structures is relatively small, especially compared with pension funds in countries such as Australia, Canada and the Netherlands. It also means people have a large number of different 'pots' built up at various employers and accumulated over time in various schemes. This proliferation of pots is exacerbated by changing regulations and policies over time.

Information aggregation would enable consumers to understand their total accumulated savings towards retirement, allowing better planning and decision-making whether using advisors or on a non-advised basis.

Looking at the fragmented nature of the market, it is not difficult to see why people struggle to understand the total value of long-term savings available for retirement. The complexity in the system is one of the key reasons why people put off making more active decisions about long-term savings.

Some benefit, in terms of increased transparency and lower unit costs, would be obtained by creating larger scale among corporate or public sector schemes, along the line of industry-wide schemes seen in Australia for example. However, a major overhaul of the fragmented market is unlikely to happen in the near term. Overcoming this hurdle of market fragmentation therefore requires aggregation of information for consumers, which could be made possible by technology and Big Data solutions.

The need to provide value-for-money services

A third hurdle that stands in the way of closing the long-term savings gap is the need to provide value-for-money services. While customers are increasingly aware of charges and fees, many savers suffer from 'agency' problems. With corporate pension schemes, the employer typically chooses which provider to use, thus determining the charges incurred by the employee. Without influence over charges, employees cannot exert pressure for lower fees. For this reason, the government has introduced charge caps to ensure that corporate schemes do not levy inappropriately high charges. Large schemes charges are generally well below the cap, due to competition among providers to manage these schemes. This competitive pressure will only increase with the rising popularity of passive funds and the growing number of digitally-led players with much lower cost business models.

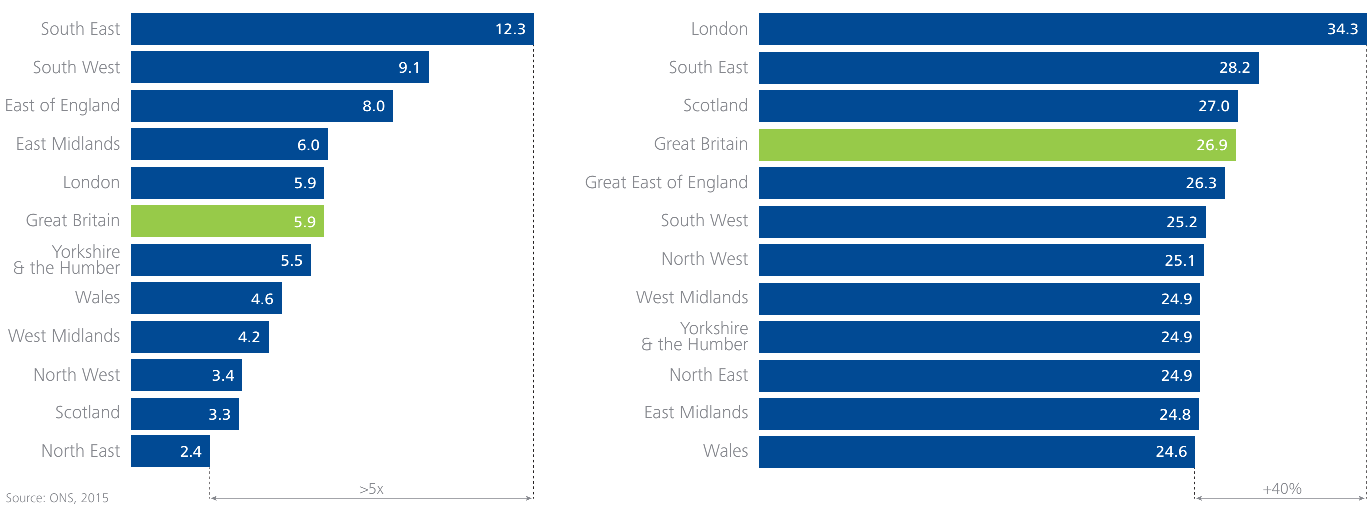
The difficulty for traditional players in lowering costs stems from the high labour and transactions costs of traditional active management, limited automation in back office, the proliferation of funds and (increasingly) the cost of compliance from increased regulation and regulatory scrutiny. Since consumers have typically been inactive participants in choosing funds, relying on their employer's default fund or the choice of their adviser, the investment management market has lacked competitive pressures. However consumer awareness of costs will increase in future due to the proliferation of direct-to-consumer offerings, pressure from regulators around the level and disclosure of fees and costs charged, and the end of commission bias following the introduction of the Retail Distribution Review.

Growing demand for flexible and tailored solutions

A final hurdle to increasing the level of long-term savings is the growing demand for tailored products and services. While the average long-term savings gap now stands at £8,000 per year, the actual shortfall for individuals depends on their circumstances. Income and financial wealth across the UK is unevenly distributed (see Figure 8). While high income earners have the capacity to save more, they will suffer a bigger drop in income at retirement if they have not contributed enough.

Many individuals are probably planning for property to be their retirement 'nest egg'. Superficially, it may seem that realising property wealth is the answer. ONS data indicates that the average net property wealth for people over 55 is just above £200,000, which is twice the average capital shortfall of £100,000 in our model for those retiring between 2015 and 2045. However, property wealth is unevenly distributed around the UK (see Figure 9). According to ONS statistics, 32% of UK population, or 7.5 million households, do not own a home; and the percentage of 25-34 year olds that are home owners has fallen over the past two decades, from 67% in 1991 to 43% in 2011.[20] This suggests that an increasing proportion of the population will be unable to use housing wealth to supplement income in later life.

Figure 8. Median net financial wealth by region (£ thousands) Gross annual earnings by region (£ thousands)



Source: ONS, 2015

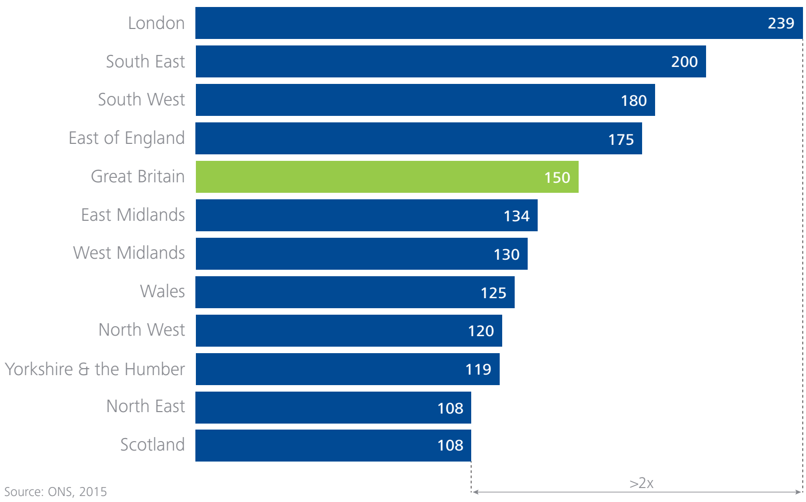
Even for those who own their own home, there are limits to the ability to use housing to supplement their retirement income. Most obviously, people need to live somewhere. True, people can downsize or move to a cheaper neighbourhood, but the amount they can realise will be well below the £200,000 average home equity.

For those who wish not to move from their home, the amount that can be realised through 'equity release' schemes will also be restricted by the number of years of expected life, and the return required by finance providers. Data from the Equity Release Council indicates that only about 22% of available property wealth is released for the average user of an equity release plan.

Personal circumstances are unique, and long-term savings needs vary by age group, income levels, individual life styles, and personal preferences. There is no one-size-fits-all answer, and solutions need to be flexible and tailored, taking personal circumstances into account. People are looking increasingly for tailored solutions, and the recent pension freedom changes have spurred further individual choice.

Property wealth and other forms of non-pension specific savings like ISAs will become increasingly important in providing for retirement income. Deloitte believes that the investment management industry can assist in closing up to 50% of the gap that remains after taking into account housing wealth and non-pension specific savings like ISAs.

Figure 9. Average net property wealth by region (£ thousands)



Source: ONS, 2015

This could be achieved through greater transparency, encouraging savings, providing higher net returns, and better matching of products and services to individual needs and preferences. We have made the following assumptions:

- Half of the reduction would come from increasing the contributions from those already saving by two percentage points. This would take the average DC contribution from 9% to 11%

- Almost 30% would come from encouraging more people to save. We have assumed a four percentage point increase in the number of people saving for retirement, which equates to almost 3 million additional.

- The remaining 20% would come from providing better returns and lower charges, for which we have assumed a 1% improvement in the annual net returns.

Solutions for the industry

Improved channel communication through digital	Customer engagement and choices can be improved, in a compliant manner, by applying behavioural science and using digital channels
Information aggregation	A standardised electronic pension 'passport' can enable the aggregation of customer information to create a holistic view of accumulated funds
Reducing costs through technology enablement	Technology solutions can be applied to reduce overall operating costs as well as provide lower costs products and services
Creating a flexible menu of products and services	Advanced data analytics can be applied to understand customer needs and tailor specific propositions to unique customer circumstances and preferences

The investment management industry can take a number of key steps to seize the opportunity that the long-term savings challenge presents. As a response to the four hurdles, there are four solutions we have identified that the industry can adopt to benefit the long-term savings market in the UK. With continuing advances in digital technology and data analytics, new ways can be found to create solutions that were previously not viable but are now available today at a lower cost.

For individuals, housing equity and non-pension specific savings like ISAs are important sources of wealth for retirement income. ISA savings currently total approximately £490 billion and the average net property wealth for people above 55 stands at around £200,000. As these sources of wealth are unevenly distributed and often form part of bequests, they will not close the long-term savings gap. Industry measures remain important. Deloitte believes that the investment management industry can assist in closing up to 50% of the long-term savings gap after taking into account housing wealth and non-pension specific savings like ISAs. This could be achieved through greater transparency, encouraging savings, providing higher net returns, and better matching of products and services to individual needs and preferences.

Improved channels of communication through digital

To increase savings levels and participation in savings plans, more can be done to inform customers. Consumer behaviour is the biggest hurdle in the long-term savings challenge, and the use of digital and mobile technology can increase engagement. Providing the right information in a simple and transparent way, supported by easy-to-use financial planning and asset allocation tools, can help customers make better decisions. Just as mobile banking has become the norm in the retail banking industry, mobile devices and other online technologies will change the way solution providers and distributors in the savings industry interact with their customers. However mobile devices need to be integrated with other channels that allow investors to access more detailed advice or guidance for making decisions that are more complex or out of their comfort zone.

In our analysis we have made the following assumptions on the impact of industry measures:

- An increase in the contributions from those already saving by two percentage points. This would take the average DC contribution from 9% to 11%.

- An increase of four percentage points in the number of people saving for retirement. This would equate to almost 3 million additional savers.

- A 1% improvement in the annual net returns from improved investment performance and lower charges.

Direct-to-consumer propositions

Due to advances in mobile and digital technology, and the growing importance of the direct-to-consumer channel, providers are required to innovate. A good example of this is Aegon's 'Retiready' proposition. This direct channel proposition is 'digital by default' and targeted at non-advised savers and the growing group of self-directed investors that are looking for more control over their finances. It allows customers to purchase and manage their Pension and ISA and provides integrated retirement planning tools.

Customer engagement is created by providing people with a 'Retiready score', which helps inform people how well prepared they are for retirement based on their understanding of long-term savings solutions and actions they have personally taken to prepare for retirement.

With investments in Big Data and information aggregation, such tools will increasingly be able to provide a comprehensive view of long-term savings, which helps customers make better informed decisions.

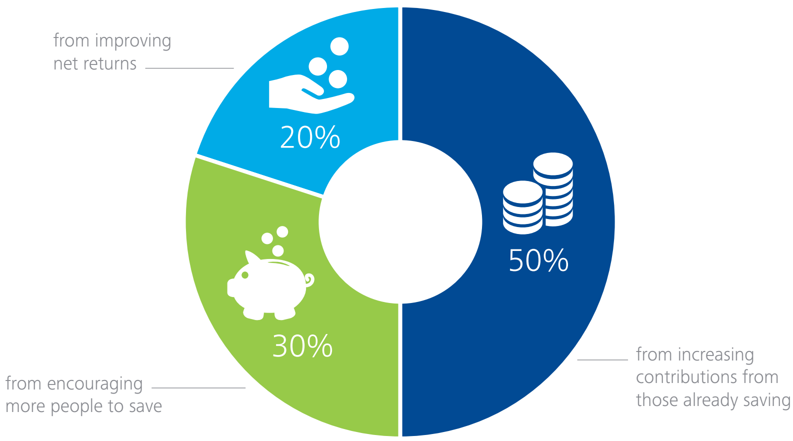
Opportunities in workplace marketing

Besides the growing importance of direct-to-consumer distribution, we see opportunities for increased sales through workplace marketing. Due to auto-enrolment the assets in private sector workplace DC schemes is projected to grow by around 9% annually to circa £1.2 trillion by 2030. As the number of people saving through their employer increases, there is an opportunity to ensure that employers get the best possible service from providers, and are also supported to give the right guidance to their employees.

Since behavioural hurdles prevent many people from making decisions about their retirement, it is important to maximise the opportunity to engage with individuals and broaden the offering as much as possible. Offering ISAs, or other options for voluntary contributions to long-term savings and retirement products though the workplace, are an important aspect of this.

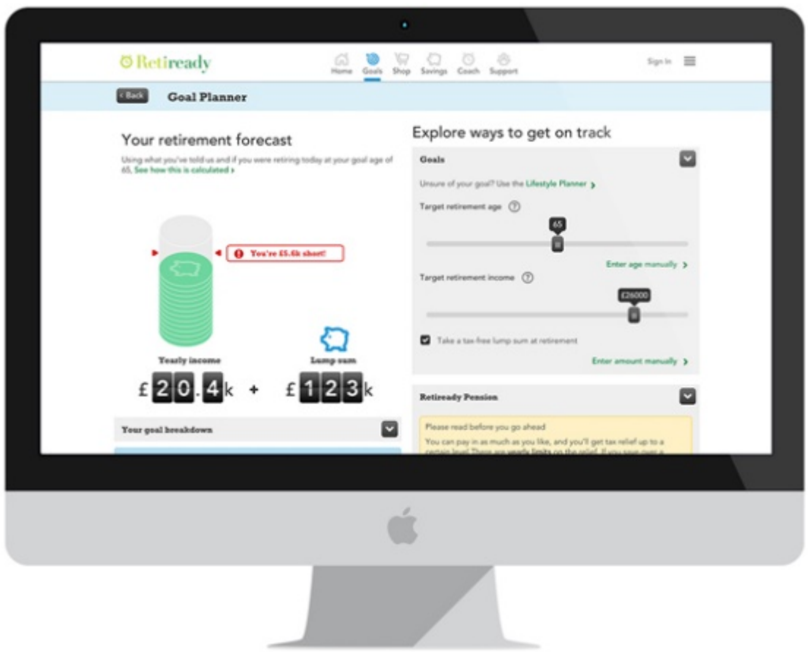
Research commissioned by Standard Life identified several opportunities in the workplace for improving the savings behaviour of employees: these were showing employees on their payslip the progress in their retirement savings, and using even numbers instead of odd ones for choosing additional retirement contribution increases above the 4% minimum (for example 2% or 4%, rather than 3% or 5%).[21]

Figure 10. Potential impact of industry solutions



Due to auto-enrolment the assets in private sector workplace DC schemes is projected to grow by around 9% annually to circa £1.2 trillion by 2030.

Figure 11. Aegon Retiready proposition



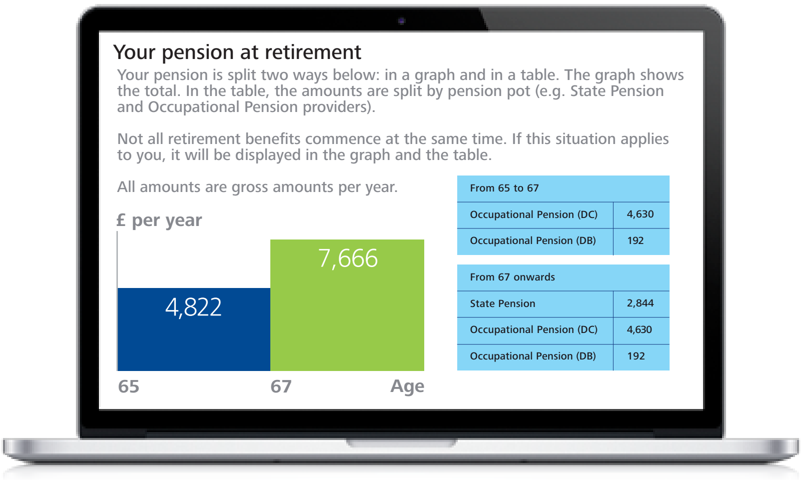
Source: Aegon Retiready, 2015

Information aggregation

There is an opportunity for the industry to help people deal with the fragmented nature of their pension pots. New members in auto-enrolment schemes will benefit from automatic transfers of their pots from October 2016, but this will cover only a small part of the population, and will not provide individuals with a holistic overview of all their entitlements.[22]

In a study into the retirement income market, the FCA has highlighted the need for a pension dashboard that allows beneficiaries to see in one place the aggregate position of all their pension pots along with their accrued and projected State Pension. Finland, Denmark, Belgium, Sweden and the Netherlands, already provide such a dashboard, and research is underway at the European level into the feasibility of a 'European Pension Tracking Service'.

Figure 12. Example of Dutch pension dashboard



Lessons can be drawn from international experience that would benefit the UK market. In the Netherlands, The Dutch Pension Register (Stichting Pensioenregister) is a joint initiative by the government agency in charge of state pensions, the pension funds and insurance companies. It provides an overview of State Pension entitlements as well as retirement savings built up in all Dutch occupational pension schemes, although individual long-term savings are not part of the dashboard. In addition to showing the current value in all pots, an estimate is provided of what income could be expected at retirement, and what the pay-out will be upon death. The service is free to use and is operated on a not-for-profit basis, with the objective of providing information to pension beneficiaries.

The Dutch solution deals with the pressing issue of transparency for the total long-term savings position of individuals, without the need for aggregation of funds. Concerns about data security are mitigated by drawing the information from data stores of pension funds and insurance companies on an as-needed-only basis, when the customer logs in. It also removes the need for a separate data store and ensures that the data is always up-to-date.

Alongside the Dutch Pension Register, and using the same infrastructure, the industry is running a separate information aggregation scheme to support financial advisors in providing uniform and accurate pension information in their advisory practice.

The fragmented nature of the UK market will present specific challenges to implementing a similar scheme. Currently there is no legislation in place for a uniform pension statement; so apart from the cost of setting up and running a dashboard website, firms may need to invest in building the required infrastructure.

However, doing so would provide the industry with significant opportunities. It would enable pension transfers and aggregation, and it would reduce significantly the burden of identifying the aggregate value of long-term savings. It may also help prevent 'lost' pension pots as they can be linked automatically through a unique customer identifier. The digital State Pension statements currently being tested could be the first element in a dashboard encompassing all retirement savings entitlements.

Reducing costs through technology enablement

With increased regulatory scrutiny of the fairness of charges and growing competition from new entrants and low cost providers, there is a need to provide value-for-money services.

Enabled by technology, more providers are offering automated portfolio management solutions at low cost. In the US companies such as Wealthfront and Motif Investing have sprung up in recent years: Nutmeg is a UK equivalent. While current assets under management with these players are still low in comparison with the established behemoths such as Vanguard and Blackrock, they are growing rapidly. This growth is driven primarily by their low cost offering, in combination with easy-to-use online and mobile platforms.

However, the industry is not sitting still, and established players are now offering their own low-cost solutions using digital tools for customer engagement. In the US Vanguard has recently launched its Personal Advice Service: this provides investment management services, together with a basic financial plan from a financial advisor and the ability to contact the advisor with any questions. This service is provided for an annual fee of 0.3%, which is significantly lower than the average 1% annual management charge that prevails in the industry.

As traditional market capitalisation-based passive investments are challenged by ‘smart beta’ products that construct indices in an alternative way, and promise enhanced returns, the evolution of active management continues. An example is the launch of NextShares in the US. NextShares are similar to traditional active managed funds, but through the use of technology certain costs have been stripped out (for example, load fees, administrative costs and trading costs). This makes them cheaper compared to actively managed funds, while providing the potential for above-index returns. Like ETFs, NextShares will be traded on exchanges, making buying and selling quicker and easier.[23]

In addition to providing lower-cost products and services, technology can be used to lower the costs of doing business. Straight-through processing and process automation using robotics can remove the need for paper handling, increase process flows, and reduce significantly the number of process steps required. While these projects require substantial upfront investment and carry execution risk, they can improve operating costs by reducing the number of staff, lowering error rates, and preventing revenue leakage.

Creating a flexible menu of products and services

As we have seen, individual wealth and retirement circumstances differ. Pensions ‘freedom’ has given new flexibility for people to draw down their long-term savings. As a result, the number of annuities sold collapsed by almost two-thirds in the year to the fourth quarter of 2014, as money was either taken as lump-sum pay-out, or channelled into more flexible drawdown products.[24]

Increasingly people will work part-time after retirement to supplement their income, and want to be more flexible around the phases in their lives that they accumulate and decumulate wealth.

Over time, the demographic changes will increase the need for decumulation products and services. By 2050, 15% of the population will be 75 or older, almost double the proportion today. All these changes together mean a more flexible menu of products and services is required.

Pensions ‘freedom’ has given new flexibility for people to draw down their long-term savings.

Flexible annuities … if we still call them that

In time, we expect the annuity market to recover some ground as innovations are introduced by providers and as people recognise the benefits of a guaranteed income stream. Innovation will come from using more personal medical data and socio-economic factors to personalise the underwriting of annuities. There is a huge opportunity for providers to apply Big Data concepts to launch more tailored annuity products.

There are also opportunities to provide flexible annuities, where pay-outs increase when personal health circumstances change, or to cover the cost of long-term care when the need arises. Deferred annuities, where the pay-out of regular income starts later, might also increase in popularity as an insurance against outliving one's savings.

As consumer research has shown that people actually prefer a stable and guaranteed income stream[25], while at the same time are averse to the term 'annuity'[26], we can expect an uptake in the demand for annuities when industry changes the framing of information and communication.

There is a huge opportunity for providers to apply Big Data concepts to launch more tailored annuity products.

The emergence of flexible drawdown

On the drawdown side, we also expect plenty of innovation. Unit-linked guaranteed products have emerged that provide some level of capital and/or income guarantees and can include death benefit guarantees. These drawdown products also provide more flexibility in the timing of accumulating and decumulating assets. This becomes increasingly attractive as more people opt for a flexible retirement age and engage more in part-time or flexible work arrangements before and after the traditional retirement age.

In this sense the boundary between accumulation and decumulation is becoming blurred and investment-based products need to provide the sought-after flexibility that customers want.

Increasingly people will use a combination of different types of savings to create the income stream they need in later life, where the State Pension and annuity-type products provide a stable guaranteed income, supplemented when required by income from investments such as ISAs, flexible drawdown or home equity.

Home equity opportunity

According to the Equity Release Council, in 2013 more than one billion pounds were released through home equity products. We foresee an increase in the use of equity release products as more people are forced to tap into housing equity to supplement their retirement income (for example, to pay care costs). These will be predominantly medium-to-high earners who may see the biggest drop in income after retirement. As with the trend in other drawdown products, we see flexible equity release becoming more popular.

In addition to creating more flexible products, leading firms in the industry will use advanced data analytic techniques to understand investors better, enabling them to tailor products to meet differing risk appetites or needs for income or liquidity. Pricing is likely to become more sophisticated, reflecting investors' sensitivity to the desired level of return or level of capital or income guarantee. In general, the industry will move from promoting the benefits of products to the value of outcomes that best match investors' needs.

The changing shape of investment management

Some important steps have been taken to ensure that more people have the means to fund their future. On a national level, there is an opportunity to capture substantial amounts of long-term savings as the UK population grows, the costs of long-term care increase, and DB schemes fall away.

Regulation has changed the shape of the industry, and individually-managed investment-based products have increased in importance, while sales of insurance-based products have fallen. At the same time, there are growing pressures on investment managers to provide better value-for-money products, calling for a re-think of costs and cost structures.

The use of technology will be critical for adapting successfully to the changing shape of society. Companies will have to become more agile and responsive in order to stay ahead in an increasingly competitive market place. In order to succeed, the following skills will become increasingly important:

- Retail and workplace marketing and communications skills.
- Technology usage, for example in digital channels and back-office processes.
- Data analytics, to identify and target customers and design bespoke products.

In the world of institutional DB schemes, these skills have not been crucial, therefore a major transformation is required for many investment managers. But this transformation must occur unless the industry is to leave itself exposed to new entrants from other industries that possess these skills, and seek to transfer them to the savings industry.

The opportunity for the investment management industry is huge, and it has a vital role in embracing solutions to address the long term retirement savings gap. It is imperative that the investment management industry adapt and continue to work with policymakers and regulators to conquer the long-term savings challenge.

The Deloitte long-term savings model

For the purpose of this analysis, the long-term savings gap is defined as:

"The additional annual savings UK citizens, retiring between 2016 and 2056, must make to attain an adequate lifestyle in retirement, relying solely on pension income".

For the size and breakdown of the UK population between 2015 and 2056 we draw upon data from the Office for National Statistics (ONS). Our baseline assumptions follow the Principal projections from the ONS. Sensitivity around the size of the population up to 2056 are based on the ONS scenarios for high and low levels of birth rates, net immigration, and life expectancy.

As proxy for an adequate lifestyle in retirement, we have used a 70% replacement rate. This aligns to the view used by the OECD and is based on rule of thumb that mortgage costs typically amount to 30% of income and they would generally be paid off around the retirement date.

The assumptions for the average retirement age have been aligned to the latest government timeline.[6] (see also table below)

In our analysis, the long-term savings gap is derived from the additional annual savings required to meet an estimated capital shortfall at retirement. This capital shortfall is calculated from the difference between the required income in retirement and the expected income in retirement. To estimate the expected income in retirement we have included all State Pension provisions as well as occupational pension savings in DB and DC schemes. The impact of non-pension specific assets (for example property, ISAs, and other savings and investments) has been excluded from the analysis. We recognise that for many these sources will be an important part of their retirement income, but assessing the level of retirement income from these sources is inherently complicated due to the range of sources and uses of those assets (for example as bequests, long-term care costs, intergenerational giving etc.).

Figure 13. Key modelling assumptions

Variable	Assumption
Replacement rate	70% average across the population; low income 90%, medium income 65%; high income 55%
Average annual return on long-term savings	5%
Retirement age	2015: 62.5 for women, 65 for men 2018: 65 for women and men 2020: 66 for women and men 2028: 67 for women and men 2035: 68 for women and men

Glossary

Accumulation	The process of building wealth for retirement. For examples through an occupational pension scheme, individual savings like ISAs, SIPPs, and through paying down a mortgage to build up home equity.
Annuity	A retirement income product that provides a guaranteed and fixed income stream from a previously accumulated pension pot or lump-sum. Typically an insurance product where the risk of guaranteed pay out until death is borne by the insurance company.
Auto-enrolment	A type of workplace pension scheme whereby the employer enrols the eligible jobholders into the scheme 'automatically'. Eligible employees are free to opt out or cease active membership, but need to take action to do so. Also referred to as Automatic Enrolment.
Decumulation	The process of spending assets in retirement. For example, converting a pension pot into annuity or drawdown product, using home equity or money from savings accounts to supplement retirement income.
Defined Benefit (DB) scheme	A pension scheme in which the retirement income benefit received by the employee is predefined through a combination of earnings history, tenure and age. The investment risk is borne by the employer.
Defined Contribution (DC) scheme	A pension scheme in which a certain amount or percentage of money is contributed each period for the benefit of the employee. The investment risk is borne by the employee.
Drawdown	A retirement income product that provides an income stream from a previously accumulated pension pot or lump-sum. Typically an investment-based product without a guaranteed income until death (i.e. the individual runs the risk outliving ones savings).
ETF	An Exchange Traded Fund is a marketable security that tracks an index, a commodity, bonds, or a basket of assets such as an index fund.
Equity release	The process of releasing an income stream or lump-sum from previously build up home equity from paying down a mortgage.
NEST	The National Employment Savings Trust (NEST) is a defined contribution workplace pension scheme in the UK, set up to facilitate auto-enrolment as part of the government's pension reforms under the Pensions Act 2008.
NS&I	National Savings and Investments, formally known as the Post Office Savings Bank and National Savings, is a state-owned savings bank in the UK.
Pension gap	In this paper we have defined the pension gap, or long-term savings gap, as the additional annual savings UK citizens, retiring between 2016 and 2056, must make to attain an adequate lifestyle in retirement, relying solely on pension income.
RDR	Retail Distribution Review is the name given to a set of rules, introduced in the UK from the start of 2013, aimed at introducing more transparency and fairness in the investment management industry. Key features of the reform included the increased knowledge and accreditation requirement for financial advisors, as well as the abolishment of commission for advisors from providers of investment products.
Replacement rate	The ratio between an individual's retirement income and his or her income received before retirement. In our report we have assumed a 70% replacement rate on average as a proxy for an adequate lifestyle in retirement. Replacement rates differ by income group, with lower income groups needing a 90%-100% replacement rate to reach an adequate retirement income, and higher income group requiring a ratio around 50%-65%.

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