UK Life & Pensions: A roadmap to succeed in a fast-changing sector

Navigating the future

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Contents

This paper puts forward a positive vision for a sector which, in our opinion, will continue playing a key role in the UK economy

Note from the authors

The life and pensions sector is an integral part of UK society, with a rich history that in many ways mirrors that of the country as a whole since industrialisation. This paper puts forward a positive vision for a sector which, in our opinion, will continue playing a key role in the UK economy. In particular, we believe that the industry's core skill of pricing and managing long term risk will be increasingly important to solve some of the country's biggest societal challenges over the coming years.

For instance, we're seeing increased collaboration between insurers, policy makers and other relevant sectors to develop a sustainable strategy for long-term care as has been seen elsewhere for other developed economies.

Provided the political and regulatory environment is supportive of such innovation, and if the industry can continue building public trust, this will provide an unrivalled opportunity for the industry to develop bespoke product and advice solutions focused on individuals who have a need for adequate support to be in place. This need was clearly set out recently in a report by the Chartered Insurance Institute[1] which also included a useful framework of potential future interventions.

This paper also argues that risk management skills, on their own, are not enough to allow insurers to succeed in a world shaped by changing customer expectations, technological innovation and continuous regulatory change. Insurers will also have to re-invent their business models to target a new generation of customers whilst sharpening their focus on core businesses and improving operational efficiency. Not every company will succeed in this dynamic environment; however, those that do will ensure that the sector remains strongly entwined in UK society.

[1] http://www.cii.co.uk/media/7774844/securing-the-financial-future-of-the-next-generation.pdf

Introduction

The UK life and pensions sector is a global centre of expertise that provides vital protection and retirement savings to people and companies, contributes significantly to the country's economy and employs hundreds of thousands of people. But for the past 20 years the sector has been buffeted by regulatory, economic and technological forces that have triggered major changes – from major shrinkage of previously profitable lines of business such as individual annuities to fierce competition from focused market entrants. Given the number of deals that have been announced in recent months, it is clear that change is already underway for even the largest of organisations.

The UK life and pensions sector is accustomed to change however the scale of the transformation still to come is significant, as illustrated in a recent report by Strategy& and TheCityUK[2], which drew a picture of the financial services industry in the UK in 2025: highly digitised and dynamic, controlling vast amounts of data and offering financial services on social media and smart devices, while using sophisticated analytics to personalise and target products and services. In addition, as with many other sectors, the UK life and pensions sector will need to consider the implications of these changes on their workforce in the future[3]. Meeting the challenges ahead for UK life and pensions sector will require long-term financial investment, an innovative mindset and a willingness to work with policymakers to improve outcomes for customers as society's demands evolve.

In this report we set out the main challenges that the UK life and pensions sector faces, and a practical roadmap to help sector players prepare for the changes ahead.

The UK life and pensions sector contributes significantly to the country's economy and employs hundreds of thousands of people

[2] https://www.pwc.co.uk/financial-services/assets/pdf/the-city-uk-report-exec.pdf
[3] https://www.pwc.com/futureworkforce

The four transformational trends

The UK's life and pensions sector isn't alone in facing a rapidly and profoundly changing environment; the financial services industry generally, as well as the wider business community, faces many of the same main challenges. Within the UK life and pensions sector, though, these changes coincide with regulatory upheaval, economic pressures and the crescendo of the ongoing debate about how we will fund our old age.

In particular, we see four transformational trends shaping the future of the life and pensions sector:

1. Demographics

The UK's population is ageing. 18% of the population is now over the age of 65 and 2.4% is over the age of 85[4]. As a result, the old age dependency ratio (OADR, the number of people over the age of 65 for every 1,000 people aged between 16 and 64) is increasing and in 2016 stood nationwide at 285. In 2016, only 11 of the UK's local authorities had an OADR of more than 500; this is projected to increase to 62 by 2026 and to 157 by 2036.

The need to fund long-term care is a critical issue for the country which will need input from governments, local councils and the private sector. In addition, with increasing life expectancy the nature of work will need to change, with all of us likely to move to a portfolio career with periods of retraining and education. This will need innovation in products to ensure that products are fit for our future working patterns. It's encouraging to see increased public acceptance of the need for change and we expect to see new initiatives emerge across the UK in years to come, including financial, health and care services providers.

18%

of the UK population is now over 65

157

Local authorities will have an OADR of more than 500 by 2036

[4] https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/articles/overviewoftheukpopulation/july2017

2. Changing customer expectations

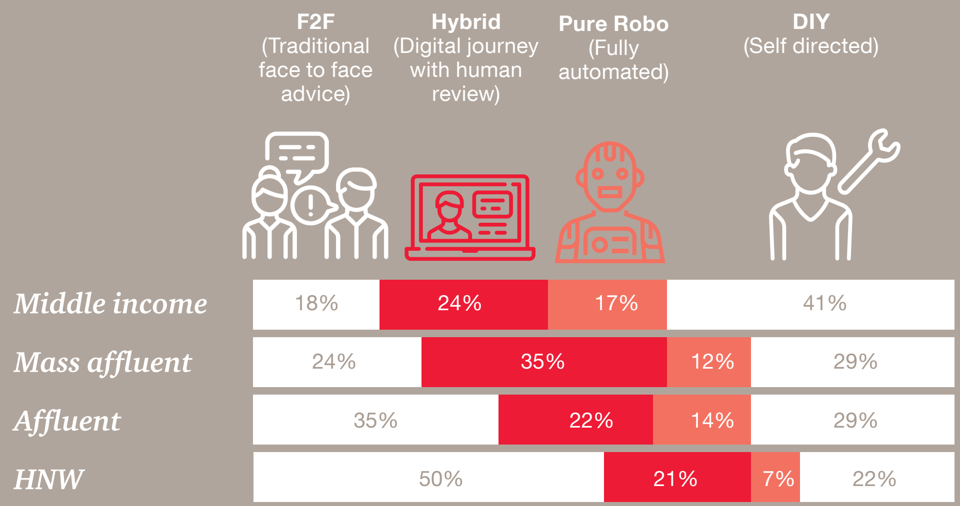
Technology has changed the way customers interact with businesses in almost every sector. People expect rapid, seamless, easy delivery of online services. It's debatable whether that's even possible with many of the complex products offered by life and pensions companies; as an added complication some products, such as life insurance, may be viewed as 'static' products in that they're typically bought infrequently and the customer has very little subsequent interaction with the provider. It's also clear that when it comes to financial services, customers have extremely diverse needs. Each customer has a different level of understanding and for the vast majority (75% across middle income and mass affluent segments[5]), knowledge and experience of investing is very limited. As a result, one of the greatest challenges for providers is how to create a compelling 'call to action' – but once this is achieved, some want to buy online with no human contact, while others want the reassurance of a human voice or face. Also in some cases the regulator is mandating the provision of advice that many customers can't afford.

Servicing customer needs in the digital age is one of the biggest challenges the life and pensions sector will face, with PwC research suggesting that robo-advice and hybrid digital-human models are increasingly being the preferred engagement model for a large proportion of UK customers (see figure 1). These new approaches to servicing customers will require employees with different skills – more administrative tasks undertaken by technology whilst employees are focused on higher value activities augmented by greater data and customer insight supplied by digital models.

75%

of middle income and mass affluent segments have limited knowledge and experience of investing

Figure 1: Robo-advice and hybrid models are the preferred service option for a significant share of the market



Source: PwC research of 400 UK customers in Q2 2016; Strategy& analysis

[5] PwC research 2016

The pace of technological change in the financial services sector is accelerating and transforming business models.

3. Emerging technology

The pace of technological change in the financial services sector is accelerating and transforming business models. Automation, advanced analytics and artificial intelligence brings huge potential to the life and pensions sector – improved efficiency, simpler products, reduced costs and the ability to better price risk. This additional capability leads to the dilemma of how much to allow for the increased ability to price risk by individual. This naturally limits the potential for pooling of risk, which is the foundation of insurance. This is both a practical and moral dilemma which will require leadership and effective working between industry and policy makers.

The impact of technological developments on underwriting also remains to be seen – there's the potential for more automatic acceptance and less underwriting as more data becomes available, although it's likely that this will lead to increased premiums for some customers.

From a customer service perspective, technology has traditionally acted as a barrier to entry for some smaller organisations. The cost of setting up and running an industrial strength data centre has changed through technological developments with the move to the cloud and the emergence of credible, variable cost software changing the traditional orthodoxies of the industry. As a result it is now possible to build and deploy at speed new market offerings where technology is now less on the critical path and the cost is less material to the overall business case.

However, the above changes also brings risks for some; the complex legacy IT infrastructure and established workforces in the larger insurers may impact their ability to adapt, leaving their business more vulnerable to new, more nimble entrants.

19%

Unsecured consumer debt up by 19% in the last 5 years

15%

Household indebtedness in the UK rose by 15% over the past five years

4. Customer behaviour

The UK's population has limited capacity, or propensity, to save long-term, in part due to real earnings being flat over the past decade. Household indebtedness in the UK rose by 15% over the past five years, from £1,588.5bn in 2012 to £1,830.1bn in 2017[6]. Unsecured consumer debt increased by 19% over the same period and is projected to reach 47% of household income by 2021. Today's generation of retirees have higher average incomes – for the first time – than the working population.

If current working patterns continue, there is the prospect of future retirees with potentially insufficient assets (or insurance) to meet the expensive costs of later life, resulting in significant societal challenges. For example, the average pension pot in the UK (in the region of £50,000[7]) is only enough to cover two years of income for an average earner.

The solution will in part come from flexible and attractive products and services for a new generation of customers – indebted, with multiple financial needs that they prioritise above retirement saving. These products and services will need to accommodate changing future working patterns, and seek to address the gap that final salary pension type arrangements offered previous generations.

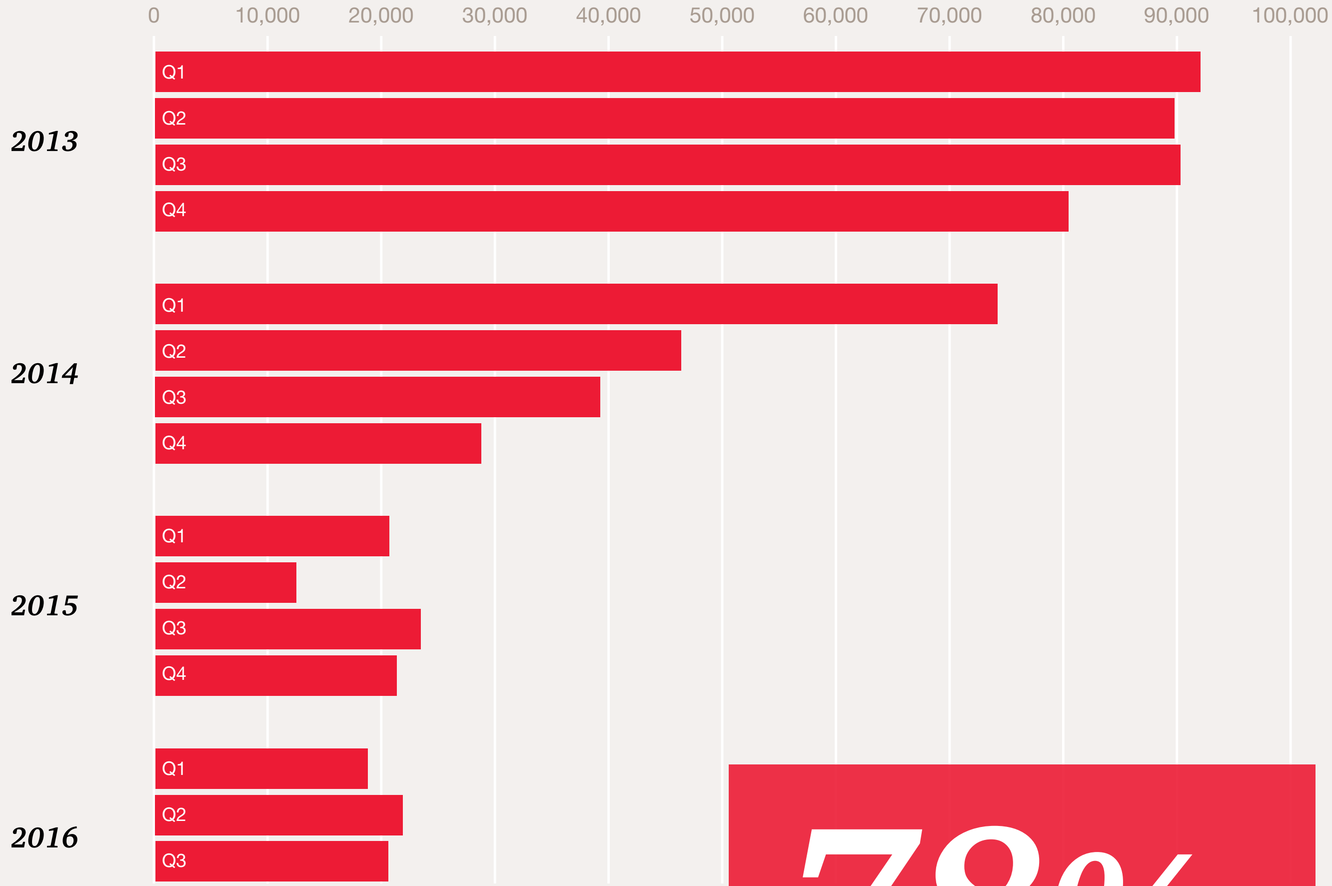
[6] https://www.theguardian.com/business/2017/sep/18/uk-debt-crisis-credit-cards-car-loans
[7] AEGON https://www.aegon.co.uk/news/over_5_5_millionpeoplesavingmoreasaresultofpensionfreedoms.html

A call for action

These profound challenges come at a time when the sector is already under economic pressure, exacerbated by a period of sustained low interest rates. Years of legislative change, too, have unsettled the industry. Barriers to entry have been lifted, increasing the competition from non-insurers. A series of policy and legislation decisions have had a serious impact on the demand for core products that have been a mainstay of the industry for decades. Some insurance products, such as onshore bonds, have become less attractive as a result; individual annuity sales, for example, dropped sharply (see figure 2) since the introduction of pension reforms in 2014.

In other words, a combination of societal, regulatory and technological change on an unprecedented scale is converging on the life and pensions sector in the UK.

Figure 2: *Number of UK annuities sold*



Source: Collated from public data available from the FCA, PRA and ABI

78%

Individual annuity sales have fallen by 78% since 2013

The future for established providers

We believe that these trends have several implications for established life and pensions providers:

- Some insurers will refocus on their core skills of long-term risk management, supplementing this through extensive collaboration with other organisations that have specialists skills (in technology, asset management, communication, retail and long-term healthcare, for example)

- At the same time, some insurers will continue their move to 'capital-lite' business models as they diverge from those who continue to seek to compete as insurers by taking on risk and generating a risk-based profit margin

- The rate of disposal of non-core businesses will increase as companies seek to meet hurdle rates of return. As a result we expect to see further consolidation, the emergence of specialists, the carving out of non-core business lines, and/or exit from the sector by some

- The market will see an increase in entrants focusing on segment niches and profitable products, making full use of new, lower-cost technology, the wider availability of data and making selective acquisition of others' non-core businesses (as seen, for example, with the large, mono line annuity specialists)

- The 'not for profit' nature of mutual life insurers and friendly societies may become more of a differentiator for certain products and services. New areas of service provision may be of particular interest if there is a perceived risk from the involvement of profit-making organisations. Equally, shareholder owned businesses may consider profit sharing type arrangements for certain new products, which could lead to a new form of 'With Profits' business.

The 'not for profit' nature of mutual life insurers and friendly societies may become more of a differentiator for certain products and services

Veterans of change

The road for life and pensions companies in the UK has been strewn with hurdles but at each stage, UK life companies have not only coped, they have adapted, finding new lines of business.

In recent years, for example, the market for bulk annuities for final salary pension schemes has grown sharply, offsetting the falling demand for individual annuities (see figure 3). The bulk annuity market is increasingly seen as a long-term growth opportunity for UK insurers, given the volume of liabilities (recently estimated by PwC at £2 trillion), and the ongoing desire of scheme sponsors to de-risk. Nevertheless, challenges remain; the bulk annuity market is competitive, and requires both strong asset expertise, and also, particularly for newer entrants, a willingness to accept a comparatively lower Return on Equity in the short term.

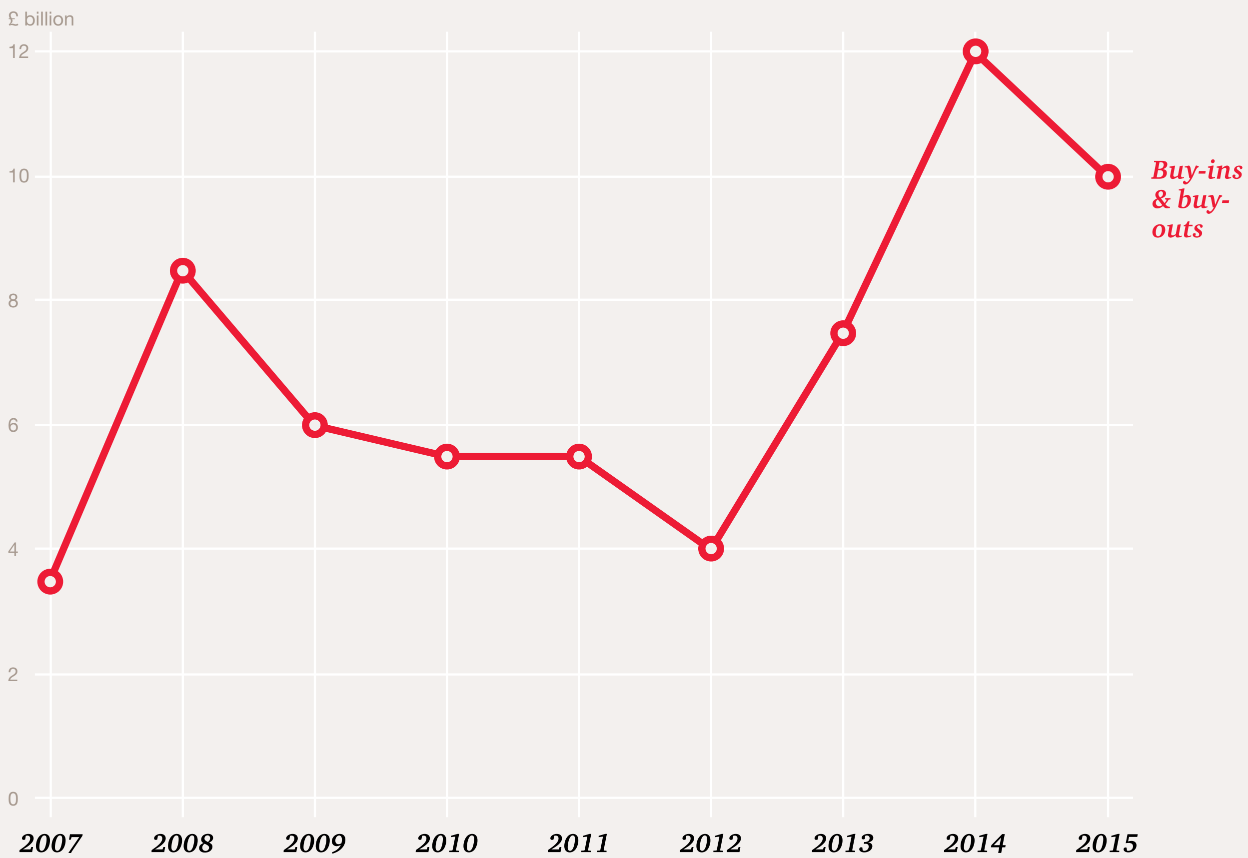
Insurers have also developed new income drawdown products, allowing them to retain customers that otherwise may have been lost at retirement. Further, insurers have increased their focus on the growing equity release mortgage market, allowing retirees to unlock significant value in property as they approach retirement; this product in turn naturally hedges annuity liability cashflows.

The UK life and pensions sector can once again rise to the challenge.

£2tn

The bulk annuity market liabilities are estimated at £2 trillion.

Figure 3: *Volumes of business by year*



Source: PwC analysis of annual report and accounts to end 2015

The long-term opportunity

Strategy& and TheCityUK's recent report[8], *A vision for a transformed, world-leading industry*, set out the challenges for the financial services sector generally and the strategic steps organisations should take to prepare for the changes ahead.

The life and pensions sector's biggest asset is its ability to assess and price for long-term uncertainty...

The life and pensions sector's biggest asset is its ability to assess and price for long-term uncertainty and provide products that pool customers' risks to meet their needs; this skill will become even more important in the future for those insurers that have the balance sheet strength to take on risk. We see two areas where insurers will be able to use this differentiating skill to the benefit of the UK as a whole: meeting the needs of a new generation of customers; and addressing the nation's retirement and long-term care funding challenges.

The challenges faced by the new generation of customers in the UK, ranging from indebtedness to uncertain retirement outcomes, necessitate new responses from the life and pensions sector. We believe that the industry is well-positioned to address these through new, flexible solutions catering for changing needs at different life stages. Simpler, more transparent products supported by effective customer engagement tools and an affordable advice model will be the key to meet the complex needs of future customers who cannot plan their finances according to the traditional accumulation-to-decumulation model.

Retirement and long-term care funding provides another opportunity for the life and pensions sector in the medium-term. The UK Government plans to publish a Green Paper[9] on care and support for older people by the summer of 2018, and has already started engaging many experts in this field. The focus of this exercise is to find a sustainable long-term solution to care provision in the context of an ageing population, involving a variety of public and private sector stakeholders.

The life and pensions sector is already actively involved in this conversation, demonstrating how its financial and risk management expertise can be applied to health and social care. It is encouraging to note that some insurers have recently started to speak more publicly about a potential link between long-term care and pensions – we expect more on this topic over the coming years.

We believe that the industry can play an even more active role in the future. One promising avenue is to use the industry's product and risk management skills to develop solutions which look at an individual's entire balance sheet, drawing from assets such as property to cover pension provision and protection gaps. This brings related societal considerations given the existing shortage of housing in the UK.

We believe that the industry is well-positioned to address these through new, flexible solutions catering for changing needs at different life stages

[8] https://www.pwc.co.uk/financial-services/assets/pdf/the-city-uk-report-exec.pdf
[9] https://www.gov.uk/government/news/government-to-set-out-proposals-to-reform-care-and-support

A practical roadmap for long-term success

We believe that insurers adopting a practical roadmap focused on three themes will be well-positioned to capture the opportunities outlined in this paper.

The life and pensions sector can play an active role by working with other financial institutions, healthcare providers and government to promote financial literacy and develop innovative solutions

1. Work with policymakers to drive sustainable change

The debate over retirement planning and the funding of long-term care will continue but it must be a collaborative effort. The life and pensions sector can play an active role by working with other financial institutions, healthcare providers and government to promote financial literacy and develop innovative solutions. For example:

- It may be that some of the structural problems outlined in this paper will require the introduction of compulsory savings to deal with the fact that as a nation we are not saving enough for our increasing lifespans. Whilst such a change would be politically challenging, the industry could play a key role in the provision of products and services for these contributions, as it has for auto enrolment for workplace pensions.
- Offering standardised equity release solutions that allow customers to decumulate their assets – in the form of property, savings and pensions and care costs – more efficiently. This would require a shared imperative for the industry and government to create new products that address public concerns.
- Working to address product gaps which meet specific societal concerns and needs, such as rising dementia rates and the increasing incidence of diabetes. We're already seeing innovation in this area.
- Combined income/health products and services for people meeting set financial criteria, underwritten by the state.

2. Re-invent the business model to target a new generation of customers

Insurers are already making use of technology to diversify their business model away from financial risk transfer alone. But the forces at play demand a radical shift in mindset; a business that's focused and driven by what customers need and demand, built on trust and an ongoing relationship.

Promote frequent, high-quality customer engagement

Until the digital age, the interaction between customer and insurer tended to be sporadic. Innovations and incentives such as fitness trackers and free gym membership are helping to build engagement and a sense of brand loyalty. Even so, insurer brands have a limited share of mind among the digitally active.

We see a unique opportunity to empower customers, making them better informed and helping them achieve better outcomes

As the volume and ease of access to customer data increases rapidly, encouraged by government-backed initiatives such as open banking and the pensions dashboard, new solutions harnessing this data are emerging. Insurers can use this data to achieve more than just slicker processes and improved pricing; we see a unique opportunity to empower customers, making them better informed and helping them achieve better outcomes.

So, more work is needed. The sector needs to focus closely on customer engagement, targeting proactively with relevant solutions at the main life stages, developing direct channels (both digital and face-to-face), testing low-cost advice solutions for customers with basic needs, and exploring the impact of ancillary services and programmes such as customer rewards.

Simple and transparent products, which can be modified after they have been sold to adapt as a customer's needs change, are essential...

Simplify products and build a compelling value proposition

Simple and transparent products, which can be modified after they have been sold to adapt as a customer's needs change, are essential if a new generation of customers are to engage with the life and pensions industry. This will also help to improve public trust in the sector which has been impacted in the past by mis-selling events and arguably complex products. Customers want to know and understand what they are buying but the complexity and rigidity of many existing products is getting in the way. Products will need to be clearly communicated, fit for purpose, and offer value for money. They'll also need to have a clear focus on customer outcomes (such as education, retirement funding or insurance at the point of need), shunning complex features that don't demonstrably meet the needs of a critical mass of customers. As a result, some insurers will look to reinvigorate the market for guaranteed solutions through a new form of simpler with profits products, most likely marketed under a different name.

Finally, we see an opportunity for insurers to harness better customer data to develop more flexible solutions that allow customer to 'draw in and out' across multiple stages in their life – to pay down student debt, save a deposit for their first home, fund their children's education and so on. These solutions will require a closer integration of risk, investments and banking products – and that's only possible through a fundamental shift in how insurers approach product design, from product-centric to customer-centric.

Explore technology bravely

Technology will play an essential role in targeting a new generation of customers, from allowing insurers to better predict and price risk, to the use of data and analytics in developing products and customer channels, to providing the real-time, rapid service that customers want. But other trends and emerging technology have the potential to transform the sector as a whole; blockchain, for example, has the potential to create an industry-wide register of policies that would allow for smooth and seamless transition between insurance providers on demand.

Organisations are already exploring the use of:

- Cognitive algorithmic processing, which gives insurers the ability to analyse vast amounts of data to predict and plan outcomes. This improves underwriting, pricing and, as a result, the insurers' overall risk profile;
- Intelligent process automation, a new generation of robotics that allows more complex processes to be fully or partially automated in areas such as finance processing, customer administration, underwriting and actuarial;
- Next generation outsourcing, a more transformative type of outsourcing where the outsourcer provides a significant uplift in technology, digital and customer service through access to innovation, skills and tools.

Simpler products, the automation of key processes and intelligent use of emerging technologies will all help to drive operational efficiency

3. Sharpen focus on core businesses and improve operational efficiency

Exiting from a non-performing product or business line can be a difficult decision to make, but once an insurer is clear what type of business it wants to be, it can allow for rapid redeployment of capital to more profitable areas of the business. Our experience has shown that the process of identifying and carving out specific parts of the business that are non-core can generate significant value if executed well.

For some of the smaller insurers, this can mean the end of the business as a standalone entity, but in the current regulatory-heavy environment, there are significant benefits to scale, and the interests of all stakeholders are often served by a decision to consolidate rather than go it alone.

For those businesses that insurers decide to retain, improving operational efficiency will be key to protect margin and generate the cash required to build new capabilities. It's clear from our recent work with clients that the drive to create new businesses and transform customer engagement will take considerable investment – and that places cost management and operational efficiency high on the list of priorities for life and pensions companies.

Large-scale product simplification (concentrating on the 20% of features that drive 80% of sales), as well as simplification of end-to-end processes has already begun, along with investment in automation. Simpler products, the automation of key processes and intelligent use of emerging technologies will all help to drive operational efficiency. We are already seeing the benefits of a flexible approach to adopting new technologies to generate commercial and customer value and expect this to become much more prevalent over the coming years.

Conclusion

These are considerable challenges; the level of change inundating the life and pensions industry is unprecedented. Over the past 20 years the sector has been hit by a series of changes that have had a profound impact on every area of business. At each stage some companies have successfully evolved and adapted, while others have lagged behind. Given the scale of disruption, now is the right time for all insurers to refocus to ensure they can evolve successfully.

Of course with change comes opportunity, and the UK's insurers are optimistic. The latest CBI/PwC financial services survey[10] showed that life companies in the UK, in common with general insurers and brokers, see opportunities for growth ahead.

And they have good reason to. The fundamentals underpinning the life and pensions sector are strong: The UK is under-insured as a nation – our retirement savings gap was £6 trillion in 2015 and is expected to rise to £25 trillion by 2050[11] – and we all have a basic desire to maintain our quality of life as we age. Reliance on the state to fund retirement and long-term care is decreasing and the population's ability to fund retirement and long term care needs from their own resources is low. Products and services that meet these needs are urgently required and will be in demand. At the same time, the UK pension buyout market continues to grow, and represents an increasing and natural source of business for UK insurers.

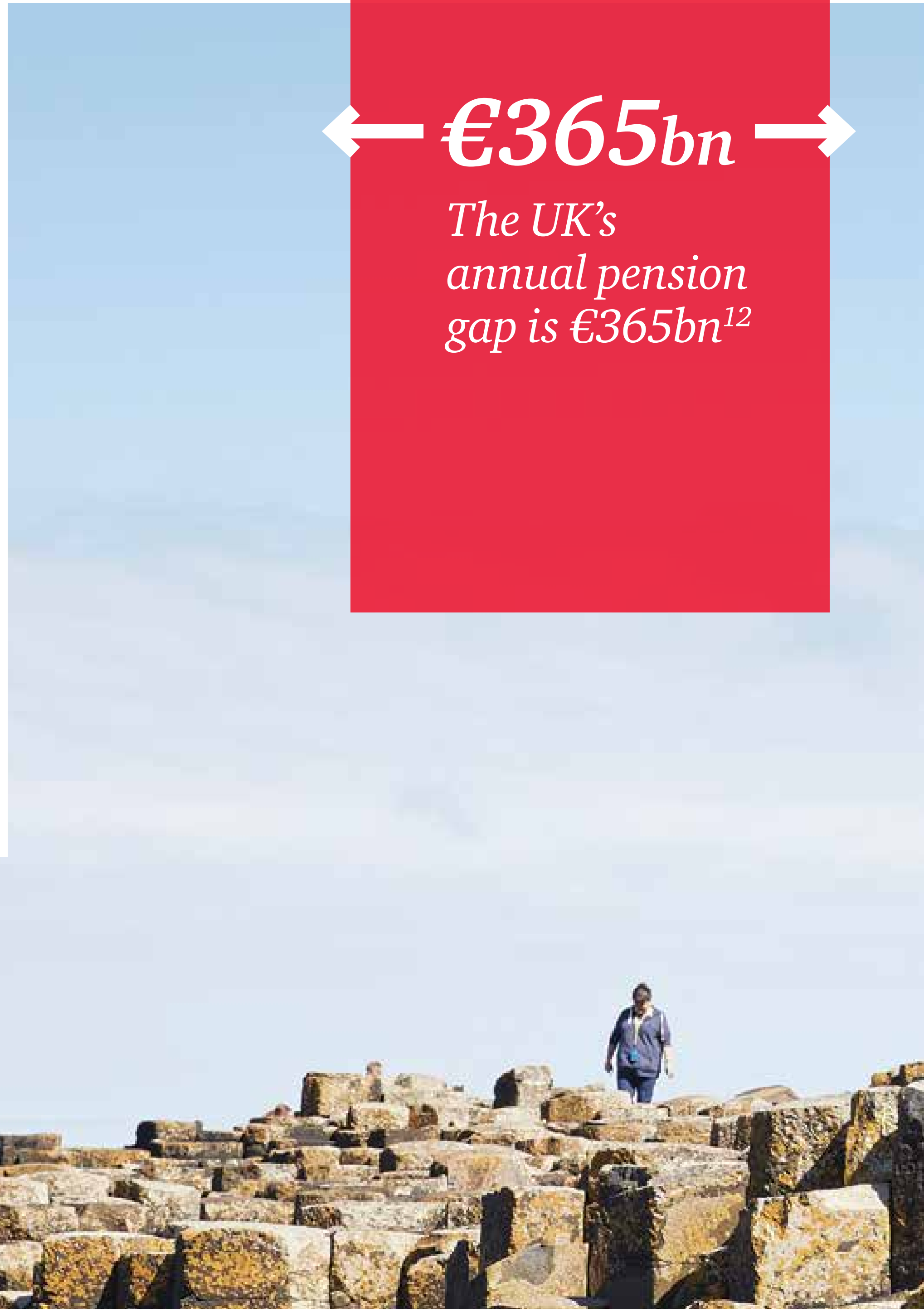
No-one is better placed than the life and pensions sector to contribute positively to the nation's challenge of meeting savings, long-term care and health needs; it has unparalleled financial and risk management expertise and a willingness to innovate with new products to meet the changing needs of customers.

Given the scale of disruption, now is the right time for all insurers to refocus to ensure they can evolve successfully.

It's perhaps inevitable that not every life and pensions company will succeed in meeting the challenges ahead but there are significant rewards ahead for those that are ready and can execute well. We hope the steps set out in our roadmap will help make sure that life and pensions companies are well prepared for the many opportunities ahead.

€365bn

The UK's annual pension gap is €365bn[12]



[10] Q2 2017 https://www.pwc.co.uk/industries/financial-services/insights/cbi-pwc-financial-services-survey-q2-2017.html
[11] World Economic Forum http://www3.weforum.org/docs/WEF_White_Paper_We_Will_Live_to_100.pdf
[12] Aviva https://www.aviva.co.uk/media-centre/story/17667/european-pension-savings-gap-reaches-2-trillion-a-/

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