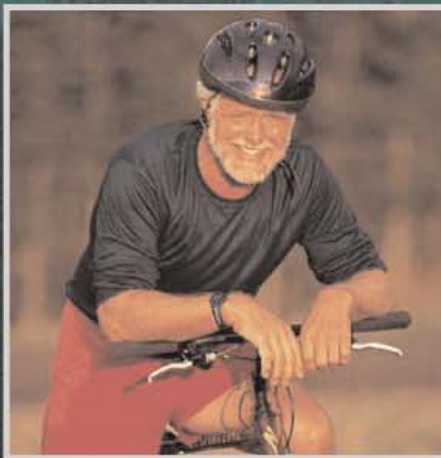




Cracking the Consumer Retirement Code



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EXECUTIVE SUMMARY

The mere mention of the term "retirement opportunity" can conjure up images of staggering financial proportions: 76 million baby boomers, controlling some \$15 trillion in assets, all hurtling towards retirement - and most looking for new financial products and advice to help them make the transition. Indeed, there's little question that the retirement market represents the single largest driver of growth and profitability for the financial services industry over the next two decades.

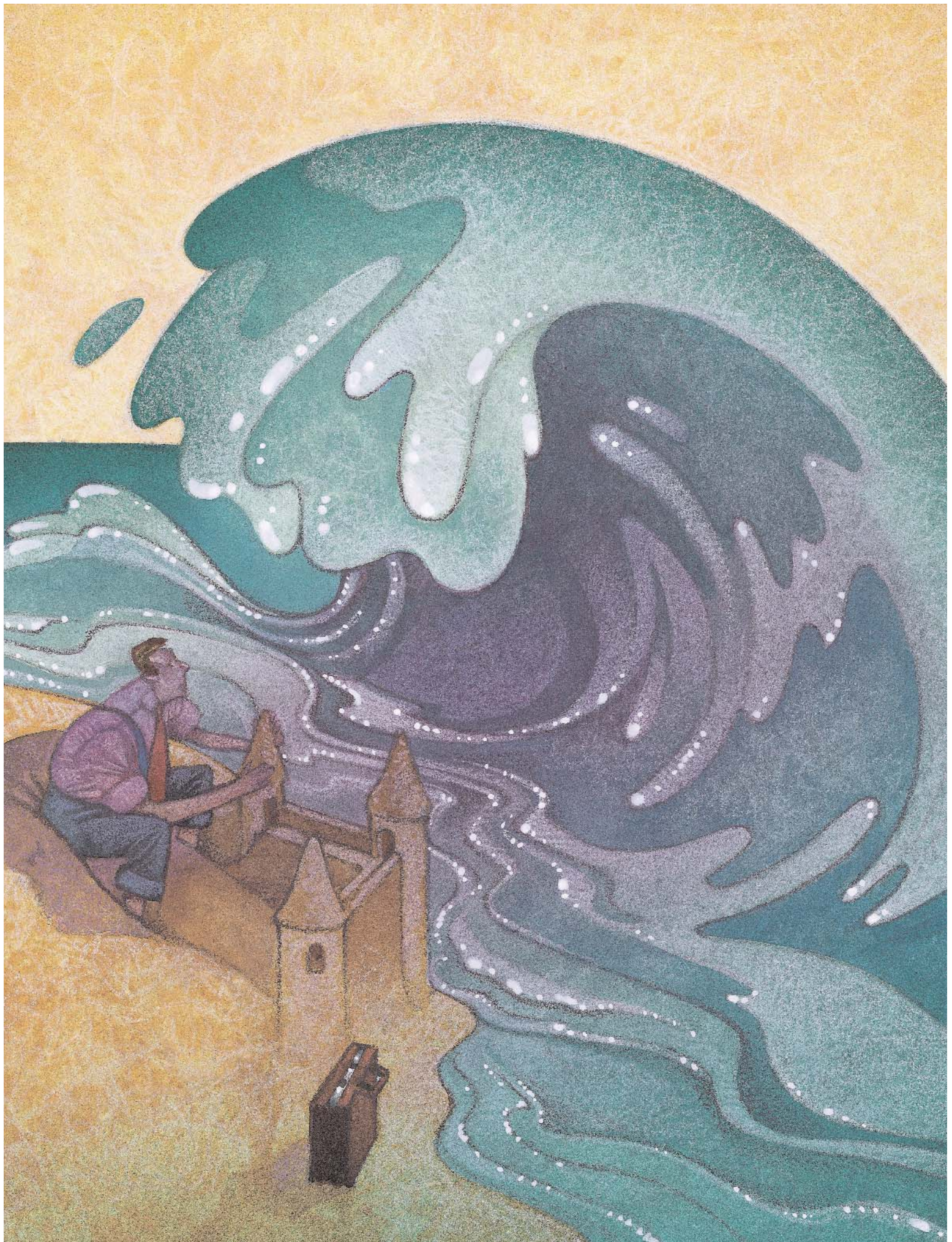
But without a deep understanding of the drivers underlying consumers' attitudes and behaviors, the retirement opportunity might just as well be called the retirement threat. And in fact, our research clearly indicates that financial players across the board are encountering some powerful resistance from consumers - resistance that is frequently manifested through declining confidence ratings in firms' retirement abilities, disloyalty, and outright abandonment of their primary financial providers. To be sure, no one financial player has come even close to cracking the consumer retirement code.

These are daunting challenges, but we believe winning firms of the future will successfully overcome them by fundamentally redefining their approaches to products, advice and distribution to meet the dramatically changing needs of consumers. While that may certainly sound like a tall order, players who don't take a hard look now at their existing business models run the very real risk of becoming irrelevant to their customers. And with the leading edge of the baby boom now 60, that risk looms near.

What's driving these beliefs? McKinsey & Company has made an extensive commitment to conducting leading-edge research on the retirement market for financial products and services. Building on our previous quantitative studies, we recently surveyed more than 3,000 retirees and pre-retirees to get a comprehensive picture of their plans, concerns and patterns of interaction with financial firms over time. Our research included a broad mix of affluent, mass-affluent and middle-market retirees and pre-retirees across the United States, ranging in age from 40 to 75. The result: a truly comprehensive picture of the retirement market from the consumer's perspective.

Our research points to conclusions in three major areas:

- While consumers' anxiety levels around the financial risks in retirement are rising rapidly, the majority hold some serious misconceptions that are jeopardizing their future living standards in retirement. In particular, pre-retirees are vastly overestimating the likelihood of working longer to make up for savings shortfalls and significantly underestimating their probable retirement expenses.
- Most financial services firms have not stepped up to the challenges facing the upcoming generation of retirees. This is reflected in consumers' ratings of financial firms' retirement capabilities, which for most channels have declined overall since 2004. Moreover, half of all consumers are switching their primary financial providers after the age 40 – often when their investable assets are at a peak.
- Although financial institutions are clearly facing some major obstacles, our research has uncovered four key opportunities for gaining competitive advantage in the retirement market. These include capturing loyal customers at a much earlier age than is commonly thought feasible, systematically leveraging the power of referrals, retooling current product and advice offerings to better meet the changing risk profile of retirees, and helping consumers monetize their home equity.



Today's consumer: Harboring serious misconceptions

As millions of baby boomers move headlong into retirement, they are being forced to bear a whole array of financial risks that previous generations didn't even have to contemplate. Unfortunately, our research reveals that not only are most consumers ill-equipped to deal with those risks, they are also clinging to several misguided beliefs that are actually intensifying them.

ANXIETY IS RISING QUICKLY

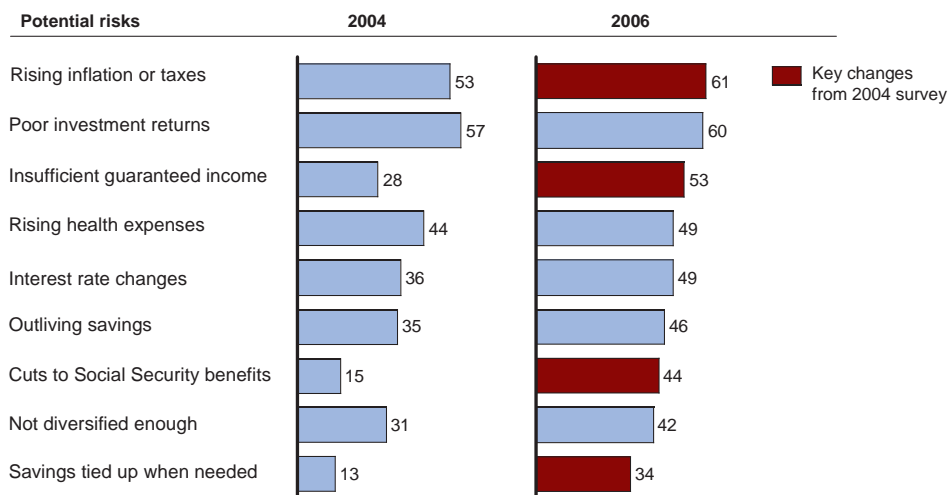
In recent times, the news coming out of the retirement front has hardly been encouraging. For starters, employers are cutting defined benefit pensions and retiree healthcare coverage at an accelerating rate – a reality that gets reinforced by the media on an almost daily basis. Meanwhile, the debate over how to shore up Social Security rages on, with no resolution in sight. And all of this is playing out against a backdrop of skyrocketing oil prices, an uncertain stock and interest-rate environment and concerns over a real estate bubble.

Little wonder, then, that consumers are feeling a little nervous these days about the financial risks they face in retirement. What is surprising, however, is the stunning pace at which their anxiety is growing: Compared to only two years ago, consumers are almost twice as concerned about whether they will have sufficient guaranteed income to last throughout retirement and are three times more worried about cuts to Social Security benefits (Exhibit 1). And in a departure from our previous surveys, consumers are now more concerned about the threat of higher inflation and tax rates to their retirement portfolio than they are about poor investment returns.

EXHIBIT 1

Anxiety levels around the financial risks in retirement are rising rapidly

Percent of pre-retirees “very concerned” about impact of following risks on their retirement



Source: McKinsey 2006 Consumer Retirement Survey

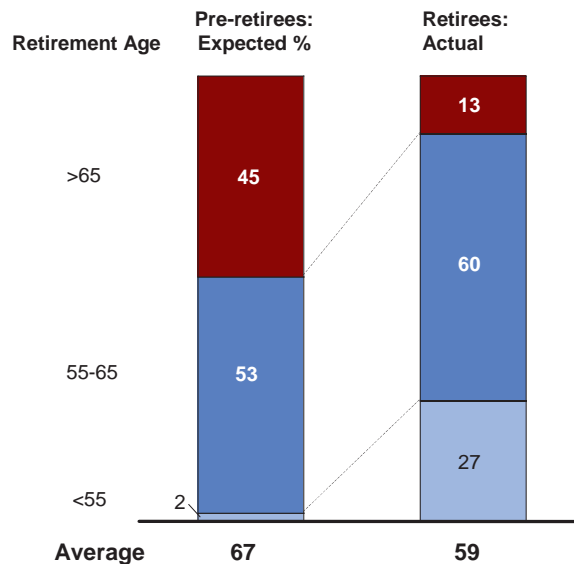
The younger the pre-retiree, the more concerned about key financial risks he or she is likely to be – and the correspondingly less likely he or she is to feel "on track" for reaching retirement goals. Less than half of those under the age of 45, for example, felt on track for retirement, compared to almost 70% of consumers over the age of 55.

LOFTY ASSUMPTIONS AROUND WORKING LONGER

One offshoot of consumers' rising anxiety levels is that more people are being spurred to plan for retirement at an earlier age: about half of pre-retirees under the age of 45 say they have started to formally plan for retirement. That certainly sounds like a step in the right direction. The problem is, consumers are feeding some serious misconceptions into those plans. Topping the list are some grave miscalculations about the likelihood of working longer to make up for savings shortfalls: Our research reveals that while almost half of all baby boomers expect to work past age 65, only 13% of retirees have actually done so (Exhibit 2). While pre-retirees expect, on average, to work until age 67, the average actual age of retirees is only 59.

EXHIBIT 2

Almost half of all baby boomers expect to work past age 65 – but only 13 percent of retirees have actually done so



Source: McKinsey 2006 Consumer Retirement Survey

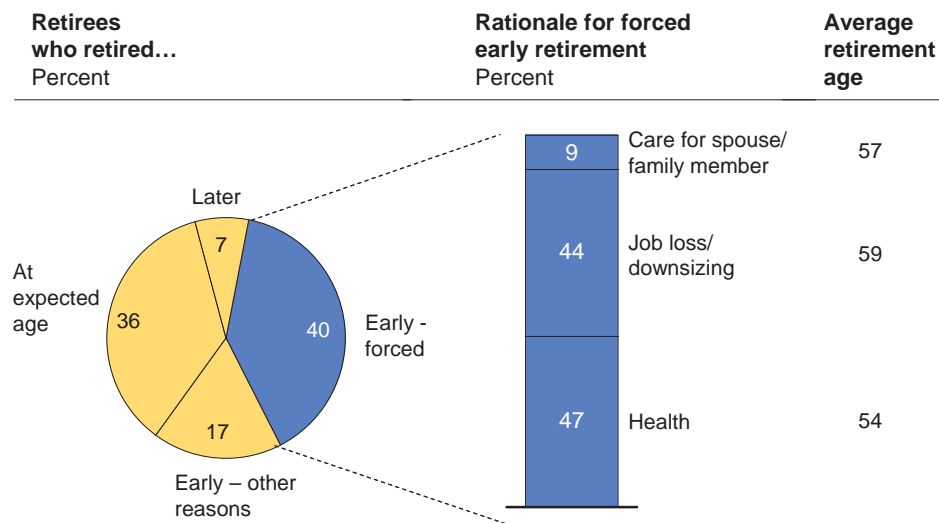
The result is a perilous double-whammy – eight fewer years of earnings power, combined with eight additional years over which to stretch existing retirement savings – that stands to put a serious dent in the retirement lifestyles of millions. Further exacerbating the situation is that people are living much longer: A 65-year-old couple today has a greater than 50% chance that one partner will live into their 90s – a reality that, even in the best of circumstances, greatly increases the risk that people will outlive their savings.

THE HARSH REALITY OF FORCED RETIREMENT

It may be tempting to assume that the average retiree left the workforce at age 59 because he or she had managed to accumulate a comfortable nest egg by that time. The reality, unfortunately, is far more sobering: A full 40% of retirees were forced to stop working earlier than they had planned, largely because of health problems or job loss (Exhibit 3). For these individuals, retirement arrived, on average, between the ages of 54 and 59.

EXHIBIT 3

A full 40 percent of retirees were forced to stop work earlier than they had planned



Source: McKinsey 2006 Consumer Retirement Survey

The numbers send a clear signal: consumers who are betting on working longer to compensate for a lack of savings are setting themselves up for a rude awakening.

While the prevalence of early forced retirement is consistently high among consumers of all affluence levels, the reasons vary significantly. For instance, those with less than \$250,000 in investable assets cited health problems as the most frequent cause of their forced retirement; consumers with assets above

that level, on the other hand, were most likely to stop working due to job loss or employee downsizing.

Of course, the baby boom generation has been rewriting the rules of society at every turn – including the conventions that apply to employment. And many boomers will undoubtedly succeed in redefining their own retirements by working longer – after all, compared to the current generation of retirees, the boomers have enjoyed access to superior medical care during their working years and are more experienced in transferring their skills from one job to another. But it would take nothing short of monumental advances on both the labor and health care fronts to reduce the incidence of forced retirement to levels that significantly lessen the nation's retirement savings gap. And the probability of those advances materializing in time for the boomer generation to enjoy their effects are, we believe, remote.

In the meantime, the numbers send a clear signal: consumers who are betting on simply working longer to compensate for a lack of savings are setting themselves up for a potentially rude awakening.

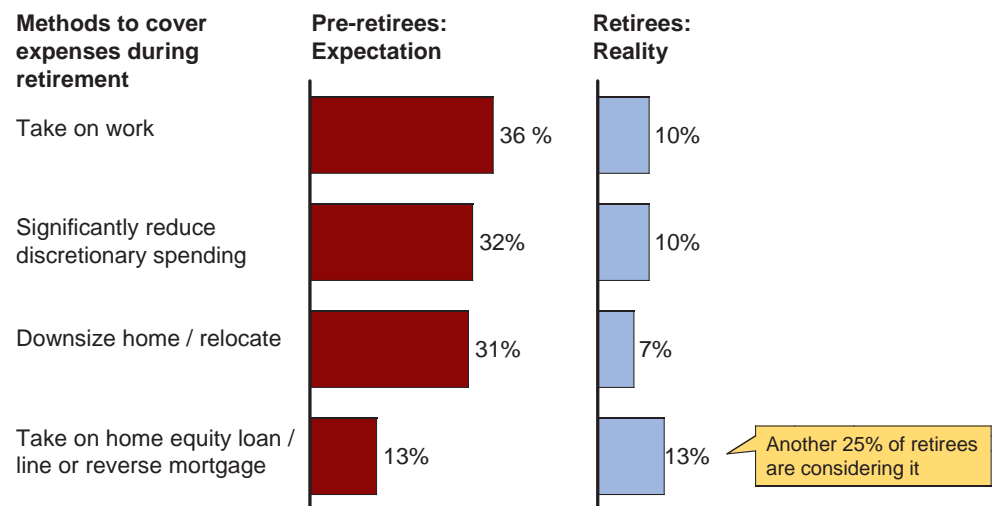
RETIREMENT SPENDING NEEDS VASTLY UNDERESTIMATED

If working longer isn't a silver bullet to solving the retirement funding problem, conventional wisdom among baby boomers holds that they can just reduce their retirement spending – and 32% of our survey respondents said they plan to do just that. But here again, reality paints a starkly different picture: Only 10% of retirees say they have been able to

significantly reduce their expenditures (Exhibit 4). Moreover, this is a fact of life that took many retirees by surprise – 43% said they had underestimated their retirement spending needs. And it isn't just the affluent who are doing the spending: in fact, the less wealthy the respondent, the more likely he or she was to be spending more in retirement compared to expectations. A frequent cause was unavoidable health care costs.

EXHIBIT 4

Pre-retirees hold strong misconceptions about methods of funding their retirement expenses



Source: McKinsey 2006 Consumer Retirement Survey

Our research also shows that pre-retirees are holding some unrealistic expectations around holding down a job in retirement. More than one-third of pre-retirees believe they will be able to do so, while a mere 10% of retirees fall into that category.

An equal proportion of boomers plan to fund their retirement lifestyles by selling their homes and downsizing and/or relocating. But our survey reveals that more than 90% of retirees have, in fact, chosen to remain in their existing homes and have no intention of moving any time soon. As an alternative to selling their homes, an increasing number of retirees are

choosing instead to borrow against their accumulated home equity to fund their retirement lifestyles – as we will discuss later in more detail, we expect that trend to continue.



Financial institutions: Not stepping up to the challenge

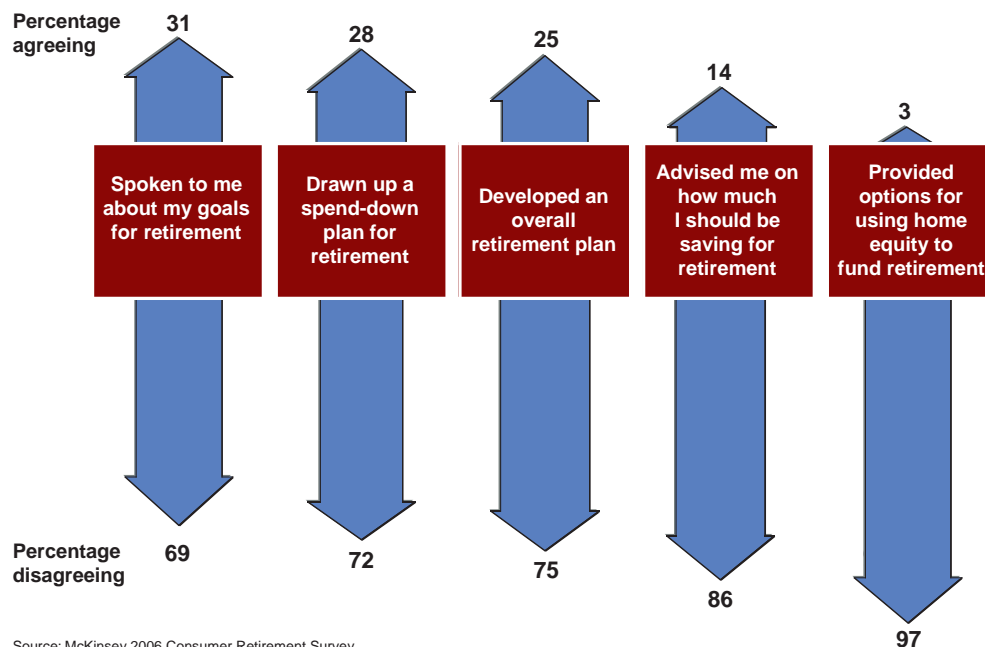
At first blush, the combination of consumers' high anxiety levels and serious misconceptions around retirement would seem to create the ideal opportunity for firms to attract customers through better products and advice. And to be sure, that's a goal that virtually every major financial institution in America is now actively pursuing. But in the minds of consumers, most are falling well short of attaining it – and have a long way to go.

RETIREMENT ADVICE IS IN SHORT SUPPLY

Notwithstanding the fact that consumers are in dire need of better guidance, fewer than one-third of our survey respondents claimed to have received even the most rudimentary forms of retirement advice from their financial providers (Exhibit 5).

EXHIBIT 5

Few consumers have received retirement-specific advice from their financial providers



Moreover, our research uncovered a widespread belief among consumers that financial advisors are primarily interested in "pushing products," as opposed to providing unbiased retirement advice, and are placing their own compensation objectives above the interests of their customers. While these results were similar across almost all channels, one notable exception to the pervasive sentiment of consumer skepticism occurred within the independent financial advisor channel. Here, retirees and pre-retirees alike claimed to be receiving a significantly higher level of retirement advice than consumers utilizing any other channel. At the same time, IFA's scored the highest marks

along such key customer satisfaction dimensions as product knowledge and overall advice capabilities.

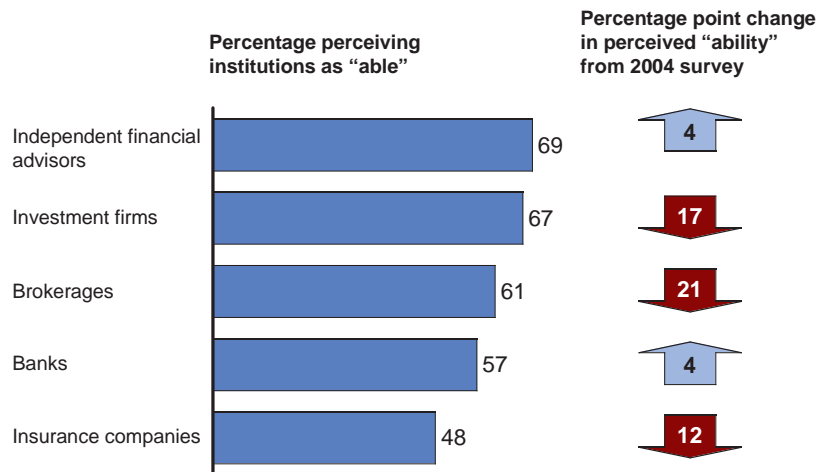
CONSUMERS' PERCEPTIONS OF FINANCIAL FIRMS ARE DECLINING

The perceived dearth of high-quality advice, combined with consumers' heightened anxieties around the financial risks they now face, has led to an unpleasant result for financial firms: Consumers' perceptions of their retirement capabilities have actually declined for most channels since we last measured them in 2004 (Exhibit 6).

EXHIBIT 6

Investment firms, brokerages and insurance companies are facing declining ratings from consumers on their retirement capabilities

Question: How would you describe the ability of the following institutions to address your retirement needs?



Source: McKinsey 2006 Consumer Retirement Survey

In particular, the ratings for investment firms and brokerages have trended down significantly since our last survey, by 17 and 21 percentage points respectively. Brokerages tended to receive low marks from consumers on their ability to deliver objective advice that was not influenced by their compensation structure. Investment companies, on the other hand, suffered from a perception that they lack the capability to provide adequate levels of personal attention and advice. As a result, the IFA channel has now overtaken

both brokerages and investment companies – and is gaining ground – due largely to its perceived lack of the aforementioned conflicts and advice shortcomings.

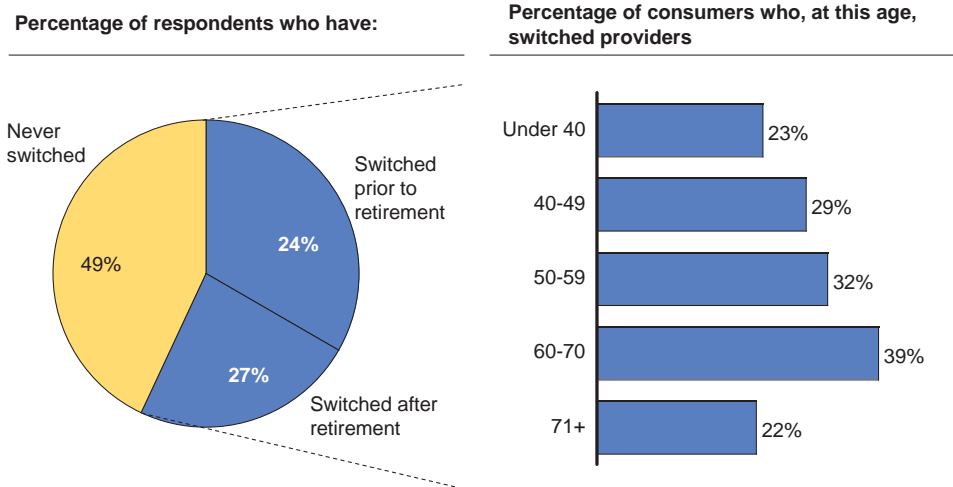
Finally, while no one channel is currently dominating the retirement market, insurance companies are definitely starting the race at the back of the pack: Not only did consumers rate them dead last in terms of their retirement capabilities, but they've also lost ground since 2004. A key reason for this last-place positioning is the relatively low score consumers give insurers on their ability to provide high-quality, comprehensive financial advice.

HEAVY SWITCHING OF FINANCIAL PROVIDERS AFTER AGE 40

A crucial implication of consumers' low (and frequently declining) confidence in financial firms is that it is often translating into active disloyalty. Indeed, our research shows that more than half switch their primary financial provider after the age of 40 – often when assets are at a peak – with those switches split almost equally between pre- and post-retirement (Exhibit 7).

EXHIBIT 7

More than half of all consumers switch their primary financial providers at some point in time



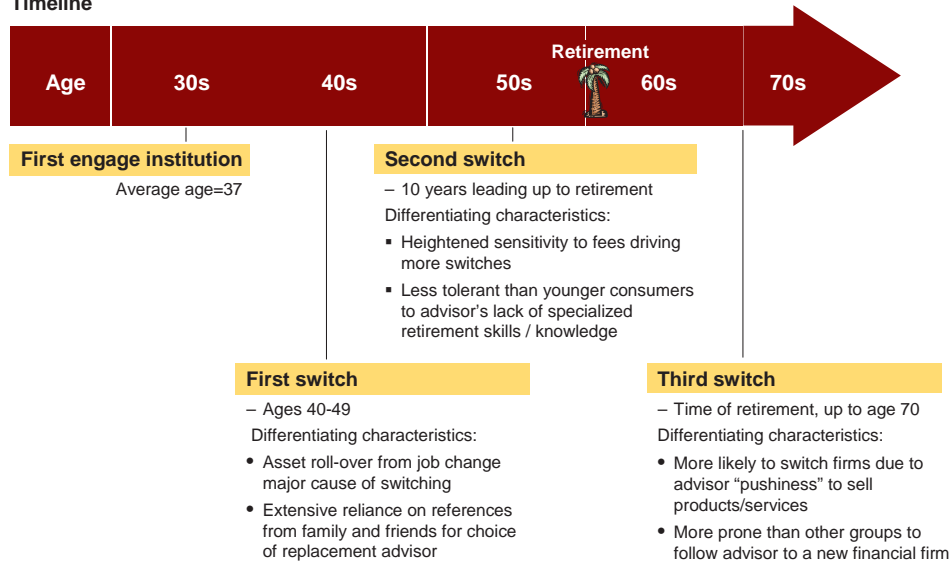
Source: McKinsey 2006 Consumer Retirement Survey

As we trace consumers' relationships with their financial institutions over time, three key "money in motion" windows emerge, during which the bulk of switching activity occurs (Exhibit 8). In all three cases, poor investment performance and lack of personal attention are major contributors to the switching phenomenon. But looking beyond those two ubiquitous sources of dissatisfaction, we begin to see some significant differences. During the first switching window, which typically takes place between the ages of 40 and 49, asset transfers are spurred foremost by rollovers upon job changes. Moreover, this group of consumers tends to rely heavily on references from family, friends and their employers for their choice of replacement advisor.

EXHIBIT 8

Consumers transfer their assets to other financial institutions during three key "money in motion" windows

Timeline



Source: McKinsey 2006 Consumer Retirement Survey

The second switching period, which typically occurs during the decade immediately preceding retirement, is characterized by consumers' heightened sensitivity to fees. This group of switchers is also far less tolerant than their younger counterparts to a financial advisor's lack of specialized skills and knowledge – at this stage, consumers tend to become more aware of the need for holistic retirement advice, including such specialized elements as insurance and tax planning.

Players targeting the newly retired should take heed: this segment is more likely than any other to switch financial providers if they feel "pushed" to buy products or services.

The last major switching window occurs after retirement, but generally before the age of 70. By this point, investable assets are often at their peak, making this group of consumers a highly desirable segment for financial firms. But players should take heed: this segment is more likely than any other to switch financial providers if they

feel "pushed" to buy products or services. Another distinguishing feature of these switchers is their relative willingness, compared to younger consumers, to follow advisors who move to different firms. This is particularly true of those retirees who view their advisors as comprehensive retirement planners, not just "product pushers."

NO SINGLE CHANNEL IS WINNING OVER SWITCHERS

So where do switchers take their assets when they leave their initial financial providers? The answer is that they generally exhibit no more loyalty to channels than they do to individual firms: More than two-thirds of consumers switch channels when they move their assets (Exhibit 9).

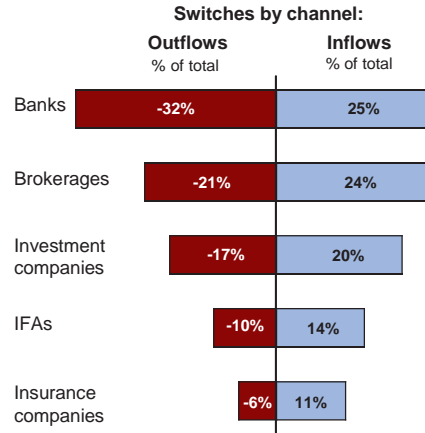
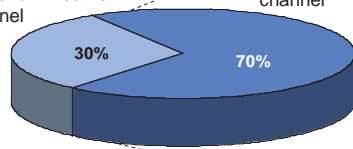
While switching occurs with a fair degree of regularity between all the major channels, brokerage and investment firms tend to swap each others' customers more frequently than any other two channels. Banks, meanwhile, experience the highest proportion of outflows due to poor investment performance. And finally, people who switch channels due to a lack of personal attention move most often to the IFA channel.

EXHIBIT 9

More than two-thirds of consumers switch channels when they move their assets

Percentage of consumers who switched institutions and moved their assets...

...to another institution in same channel



Totals do not add up to 100% due to exclusion of firms not classifiable in above channels

Source: McKinsey 2006 Consumer Retirement Survey



Four key opportunities to gain competitive advantage in the retirement market

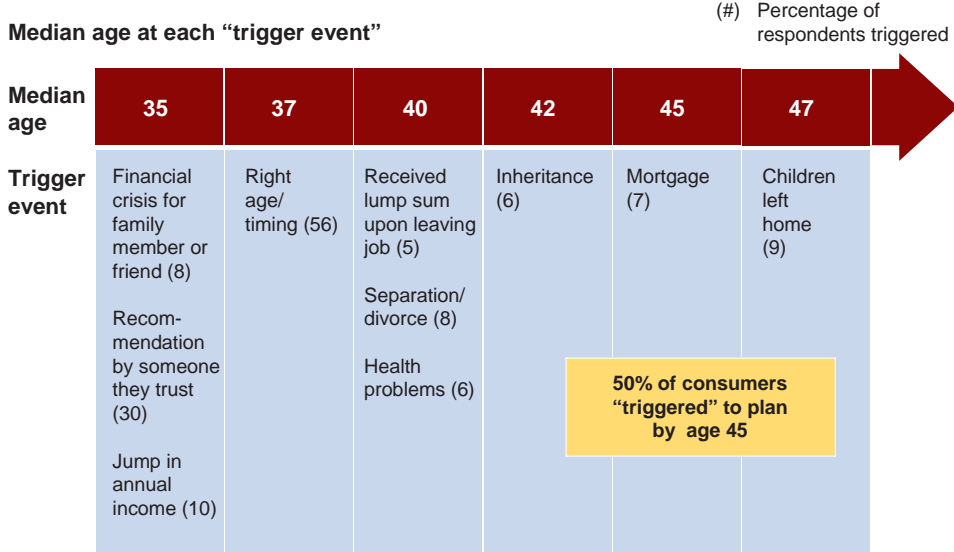
Although financial services companies clearly face some major hurdles in gaining the confidence of consumers, the news isn't all bad. Indeed, our research has uncovered four major opportunities for financial firms to enhance their long-run competitive positioning in the retirement marketplace.

1. TO CAPTURE LONG-TERM LOYALTY, AIM YOUNGER

Conventional wisdom holds that retirement does not become a front-burner issue for most consumers until they are within a decade or so of stopping full-time employment – up to that point, the thinking goes, commitments like mortgages and college educations take far more precedence. But our research shows that younger generations are planning for retirement much earlier than did their predecessors: Almost half of the pre-retirees we surveyed said they had started to plan for retirement (defined here as developing a formal budget to achieve goals) by their mid-thirties. But only about one-quarter of current retirees had started that young. This discrepancy is due in no small part to the significant uptick in pre-retirees' anxiety levels outlined previously. More specifically, our research reveals 10 major "triggering events" that are spurring more than 50% of today's pre-retirees to take retirement planning action before the age of the 45 (Exhibit 10).

EXHIBIT 10

Most "triggers" that spur consumers to plan for retirement occur before age 45



Source: McKinsey 2006 Consumer Retirement Survey

For financial service firms, this shift toward younger planning carries with it some crucial implications. Foremost among these is that firms have an opportunity to lock-in loyal customers at a younger age. The flip side of that coin, of course, is that they run the risk of losing out permanently on the

business of consumers they fail to target sufficiently early. As we have noted, about half of all consumers switch their primary financial provider at some point in their financial lifetimes – which also means that about half do not. Of this latter group of loyalists, our research indicates that most started retirement planning and engaging with advisors before the age of 45, thus making this younger segment an extremely attractive target.

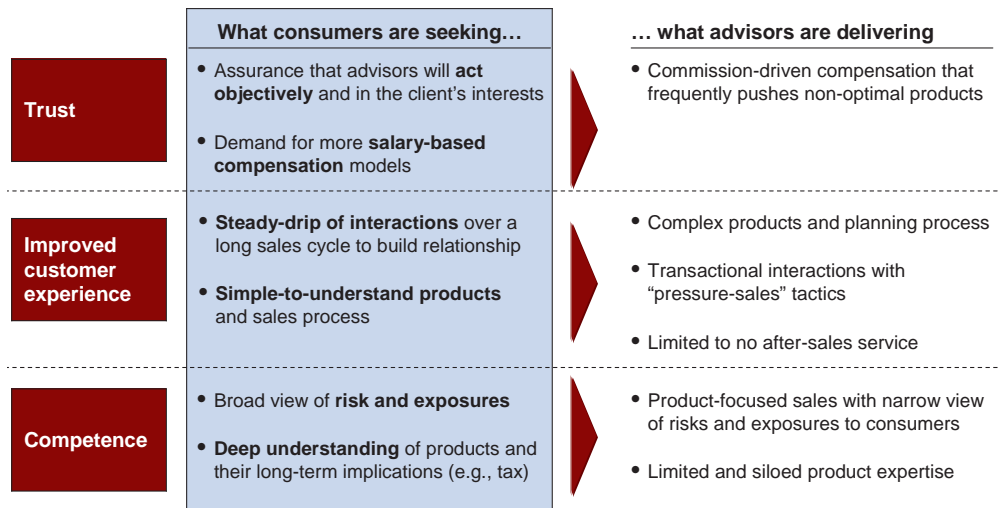
Clearly, firms that are willing to make a commitment to forging solid relationships with consumers during those earlier years, when asset levels may be modest, are very likely to find that the investment pays off handsomely over the longer haul.

2. RETOOL PRODUCT AND ADVICE OFFERINGS

Of course, a critical element of winning over the long-term loyalty of younger and older consumers alike is a financial firm's ability to deliver high-quality products and advice over an extended period of time. As detailed previously, the majority of players in the retirement arena today are falling short in this regard. Moving forward, winning firms will take the lead in developing next-generation products and advice that fulfill consumers' needs along the key dimension of trust, customer experience and competence (Exhibit 11).

EXHIBIT 11

Winning firms will retool their retirement-oriented products and advice to meet the changing needs of consumers



In our research with advisors, we have noticed some key traits among top producers who have successfully penetrated the retirement market. First, they typically position themselves as retirement "consultants" or "counselors," as opposed to product sellers. They often rely on referrals to capture clients (more on that in the next point) and are willing to ride out a sales cycle that can often last months. Many invest heavily in client education, through such means as private seminars and newsletters. And given the complexity of tax, insurance, health-care and other retirement-related issues, firms employing team-based service models, with experts drawn from several specialized disciplines, stand to be highly effective competitors.

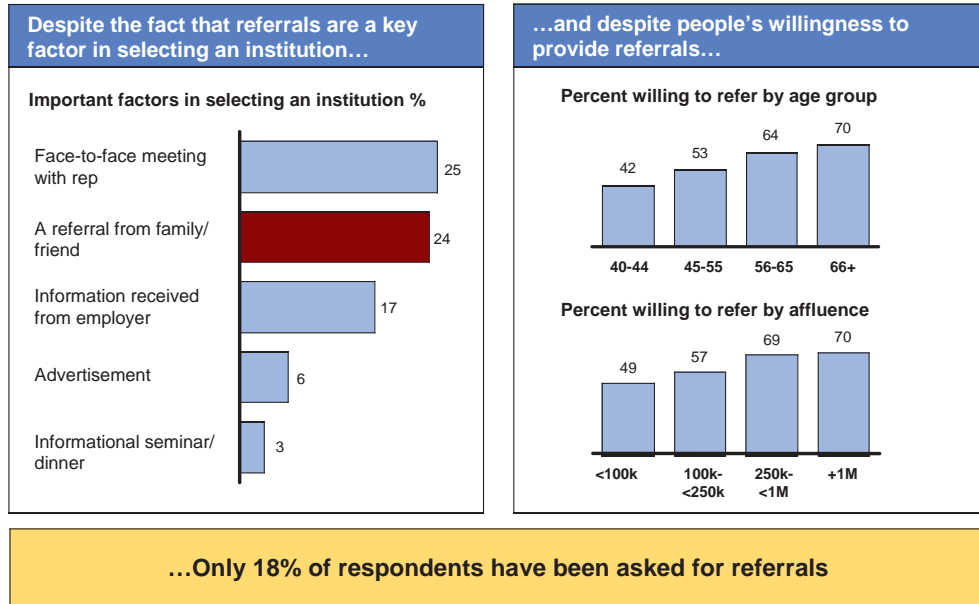
On the product side, we believe that financial firms have a unique opportunity to launch a new generation of products that address risk management. For example, structured investment products can provide a basic level of principal protection to the retiree, while also allowing him to share in any upside gains. At the same time, simplicity will be key. For evidence, one need only look at the recent experience of the mutual fund industry. During most of the past decade, pension plan sponsors offered a dizzying array of fund choices to 401(k) participants, in the spirit of offering employees a full array of options. Yet, over the past few years, target maturity mutual funds – the ultimate in product simplification – have exploded in popularity and continue to gather assets at a pace that far outstrips virtually all other fund categories.

3. SYSTEMATICALLY LEVERAGE THE POWER OF REFERRALS

Assuming they have an adequate arsenal of high-quality products and advice, financial firms have an enormous opportunity to better leverage the power of referrals as a key acquisition source. As we noted above, top retirement producers are well aware of referrals' effectiveness and employ them frequently. The same cannot be said, however, for financial firms in general: even though referrals are a key factor in consumers' selection of a financial institution – and despite the fact that most people are more than willing to provide one – only 18% of consumers have actually been asked for a referral (Exhibit 12).

EXHIBIT 12

Financial institutions are underutilizing referrals – a key acquisition source



Source: McKinsey 2006 Consumer Retirement Survey

4. HELP MONETIZE HOME EQUITY

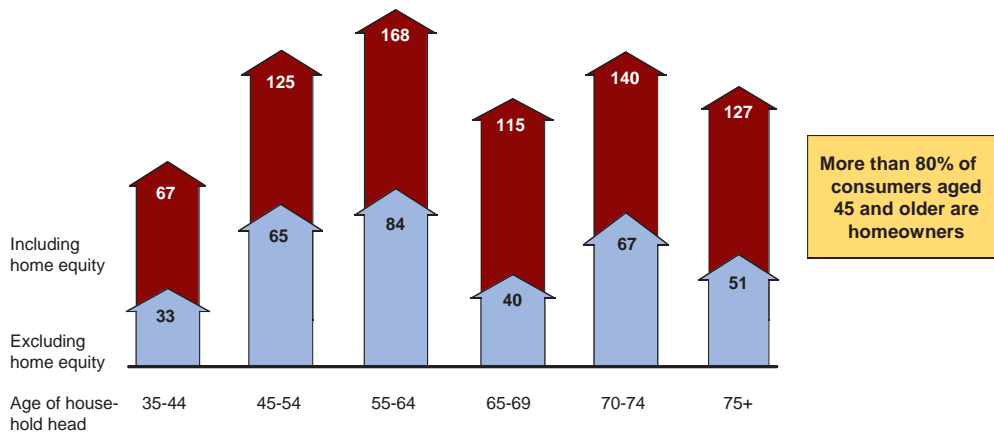
Looking ahead, we believe that home equity will play an increasingly important role in the retirement market. More than 80% of American retirees and near-retirees are homeowners, and they are sitting on more than \$3 trillion in untapped home equity. About half of the average middle-class boomer's net worth resides in his real estate – even in the event of a major hit to housing prices, that proportion would remain substantial (Exhibit 13).

Equally important, the current model of attempting to ratchet up savings in order to fund retirement is simply inadequate for a very large swath of the massive baby boom population now headed for retirement. Consider, for instance, the typical middle-class 60-year-old boomer who has \$130,000 in his 401(k) account (the average for that age), no defined benefit pension and wants to retire in five years' time with his current lifestyle intact. If he relies solely on his 401(k) savings, he'll fall short of his goal by more than one-third. And as we've noted, there's about a 40% chance he won't have the choice to work longer.

EXHIBIT 13

To effectively serve the next generation of retirees, financial firms must consider home equity

Median net household worth, by age group
\$ thousands



Source: SRI MacroMonitor, 2005; McKinsey analysis

That leaves home equity. Many boomers will undoubtedly choose to monetize that equity by selling the family home and moving to a less expensive area. But our survey reveals that more than 90% of retirees have, in fact, remained in their existing homes and are loathe to move from their neighborhoods.

The alternative, then, is to borrow against that home equity to fund retirement. This is hardly a new concept: Federally insured reverse mortgages have been available to US homeowners since the early 1990's and in recent years, new originations have been growing at a double-digit rate. Nevertheless, reverse mortgages have yet to make a serious dent in the marketplace: to date, they have been embraced by about only 1% of all eligible consumers. As we've outlined above, demand is now poised to soar. But before that can happen, we believe several changes must take place on the supply side.

First, a common theme arising from our consumer focus groups is that reverse mortgages are extremely complicated, often to the point of creating "buyer's paralysis." For instance, homeowners must choose among multiple forms of reverse mortgage payment types, with the optimal choice depending on a host of factors including life expectancy, future appreciation in housing

prices and interest rates movements – all of which, of course, are unknowable at the time of origination. Further diminishing the appeal of reverse mortgages are their relatively high fees, which can top 10% of the loan amount.

Indeed, the sheer complexity and cost associated with reverse mortgages underscores the need for comprehensive consumer education and advice. Here again, however, much work remains: a mere 3% of our survey respondents said their financial advisor had even broached the subject of using home equity to fund retirement - let alone offer any guidance on specific product suitability.

The good news is that none of these factors represents an insurmountable barrier. And as consumer demand for reverse mortgages continues to increase, we expect increased competition to spur innovation and improvement. One thing is certain: Financial firms that choose to ignore altogether the looming significance of home equity in the overall retirement equation will be doing so at their peril.

As the biggest demographic wave in our country's history heads for retirement, financial services firms have an opportunity to step up and play a crucial role in ensuring the financial well-being of retired Americans. Future winners will fundamentally redefine their products and advice to meet the dramatically changing needs of consumers. Although this transformation may be challenging for many players, those that take forward-looking action today will most likely be ensuring their own future prospects as well.

ABOUT MCKINSEY & COMPANY

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For more information about McKinsey & Company's consumer retirement initiative, please contact:

David Hunt

Director
(212) 446-7708
david_hunt@mckinsey.com

Joanna Rotenberg

Associate Principal
(416) 313-3765
joanna_rotenberg@mckinsey.com

Peter Walker

Director
(212) 446-8580
peter_walker@mckinsey.com

Janice Revell

Practice Knowledge Specialist
(212) 446-8447
janice_revell@mckinsey.com

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