



Technology, governance and risk: can new thinking on three issues bring retirement security for millions?

Global pension and retirement
market outlook



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Executive summary

We recently interviewed 50 public and private sector stakeholders, corporate pension and retirement organizations, and asset managers. Collectively, these represent more than \$10 trillion in assets under management (AUM). Several key observations emerged from the survey response:

- ▶ The importance of social security, pension and retirement providers
- ▶ Gaps in pension governance, operational maturity, investment risk and operating models
- ▶ Challenges of increased stakeholder, regulatory and service provider scrutiny
- ▶ Technology and lower returns driving pension investment

Respondents' diversity regarding assets, liabilities and stakeholders reveal varying levels of "exposure" to change. Drivers include asset growth, lower returns and increased market volatility, coupled with higher investment risk taking and global diversification in new markets and asset classes. Governments, regulators and boards must ask themselves one

key question: Are our frameworks and capabilities commensurate and aligned to the new world and to our roles as fiduciaries for the financial and retirement well-being of millions – as managers of pension and retirement assets and as long-term investors?

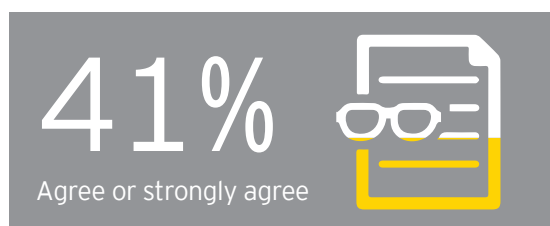
Providers are sandwiched between governments and regulators, and beneficiaries and customers. The shift to customer centricity, defined contributions and the requirement for member action means that both stakeholder groups should be fully aligned.

An executive summary of our findings is available at: ey.com/pensions:

Can we reach better outcomes by reimagining pension investment and governance? In this follow-up piece, we frame 10 provocative hypotheses that are supported by EY analysis and interpretation, based on global client experiences. We encourage you to share these reports and help providers and asset managers understand the important role they play in managing pension and retirement assets globally.



Governance structures are not aligned with size and complexity



Pension and retirement providers form the world's largest group of institutional investors in terms of assets under management. This market represents varying levels of organizational agility and governance maturity – and substantial global regulatory diversity. In fact, close to half of providers say their governance structures are not aligned with their size and complexity. They cite an urgent need to significantly improve levels of governance to adequately respond to change within the industry. This is surprising for several reasons:

- 1 Providers and boards have fiduciary responsibility and must act in members' best interest – an obligation that requires many levels of governance.
- 2 "Business and management" responsibility should include fit-for-purpose governance frameworks and solutions.
- 3 The industry touts the financial well-being of members – promises that often represent the single largest asset for members, and greatest liability to providers.
- 4 Most providers act as institutional asset owners and proactively impose expectations of high corporate governance on their investees and their asset management partners.
- 5 In a post-financial crisis era, global and local regulators and policymakers increasingly focus on fit-for-purpose governance, though outcomes vary considerably with some regulators and governments still playing catch up.

Fit-for-purpose, effective and efficient governance is a pivotal element for pension and retirement providers across governments, public and private sectors to support outcome and delivery predictability. The expected maturity level must be commensurate with member size and overall importance – and, the highest level must be the default position to protect sustainability and long-term outcomes.

EY point of view

We recommend that stakeholders review and align their governance maturity and frameworks. Assessing and driving this maturity is achieved through leadership and accountability, coupled with strategic ambition, incentives and stakeholder engagement. Supporting transparency and disclosure is pivotal to enable policymakers, regulators and other stakeholders to make informed decisions. It is also paramount to retaining the long-term sustainability of asset and liability solutions and promises, as well as underlying social contracts.

Operational maturity is not aligned with size and complexity

34%

Agree or strongly agree



Although most pension and retirement providers challenge this hypothesis, 34% agree that their operational maturity needs further alignment. Research results are understandable since the industry and its stakeholders are in the midst of acknowledging and adapting to transformational changes – and are at different points in the journey. Operational considerations, organizational agility and quality of service came second – at best. Increased public scrutiny, lower returns and focus on fees and customer experience in recent years are gradually changing attention and action.

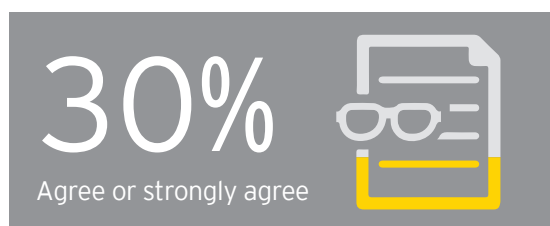
Organizational maturity is a pivotal tenet of pension and retirement providers to support the delivery of their key purpose and attract members and employers. Operational maturity is a key element of providers' fiduciary duty. Lower cost to serve and invest, higher customer satisfaction and engagement, organizational effectiveness and sustainability are common outcomes.

EY point of view

The shift to customer centricity (with members responsible for their own decisions) makes organizational maturity paramount to meet expectations, sustain delivery and empower customers to make informed decisions about their financial well-being. A tailored balanced "scorecard" is a useful tool to define stakeholder expectations, ask the tough questions and embark on transformation programs. We recommend that government, policymakers, providers, members and employers align their focus on organizational maturity to size, complexity, importance and behavior. This will enable efficient, effective and sustainable delivery of government policy and customer expectations.



Investment governance and operations are lagging



Nearly a third of pension and retirement providers think their investment governance frameworks are lagging behind the increased pools they manage. Different stakeholders are at various points in their transformation journey. All pension and retirement providers who accumulate assets have some form of investment function or governance framework in place. Historically, in times of double-digit returns, modest volatility and less public scrutiny of fees, these may have been adequate. This world has drastically changed and expectations and requirements for investment governance, functions and outcomes have risen substantially.

An increasing number of pension and retirement providers recognize the disruptive change and are systematically improving their investment governance frameworks and solutions. This raises three key questions:

- 1 Are governments and regulators doing enough to define expectations, encourage adequate focus and timely and commensurate action?
- 2 Are boards and executives doing enough to discharge their fiduciary obligation?
- 3 Are transparency and disclosure requirements fit-for-purpose to enable key stakeholders, public and beneficiaries to make informed decisions about their pension and retirement organizations beyond short-term investment returns?

EY point of view

Substantially more robust analysis and provider action is needed to meet stakeholder expectations. It is still too little and too late when we compare the research results with recent regulatory reports, public scrutiny or the activities of professional asset managers. The size of the potential benefits and risks for all stakeholders warrant utmost agility, scrutiny

and maturity to protect members' interests and investment outcomes. We encourage all pension and retirement providers to systematically and holistically review their investment governance frameworks and solutions across their entire investment value chain.

Investment risk, governance and solutions are not aligned

63%

Disagree or strongly disagree



Investment risk frameworks have been in place for several years as part of providers' fiduciary obligation and regulatory focus. This may explain why 63% of respondents disagree with the hypothesis that investment risk and governance are not aligned. While larger providers have made strides in this area, there is still significant room for improvement.

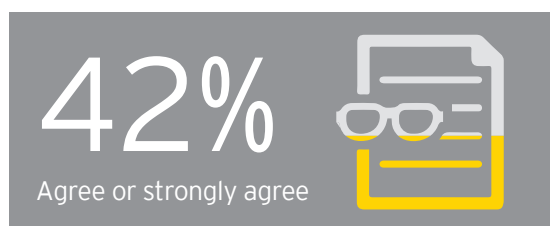
Many organizations use sophisticated techniques to define risk appetite, risk culture and conduct, and measure investment risks. There is a rapid evolution from retrospective and compliance-driven risk management frameworks to proactive and systematic management of existing and emerging risks at strategic and operational levels. Leading pension providers are increasingly adopting systematic asset and liability management solutions to adequately link investment outcomes with corresponding liabilities. This is coupled with greater regulatory focus on investment compliance, as well as challenges to effectively enable and support investment platforms with defined contribution solutions.

EY point of view

We recommend that pension and retirement providers adopt the highest level of investment risk management maturity, integrating investment risk management into a professional enterprise risk management framework. This reflects the fiduciary role that protects members' financial well-being. It aligns to an increasing demand for corporate governance and risk management that many providers deploy to their investees. Governments, regulators, members, employers and the public must support the ultimate protection of members' retirement outcomes, in which investment outcomes play an increasingly pivotal role. A systematic framework that covers all internal and external components and stakeholders is essential to support public confidence.



Investment operations and operating models need recalibration



The response to whether asset growth is pressuring investment operations and creating a need to recalibrate operating models is another reflection of the global industry's transformational stage. Respondents who agree that investment operations and operating models need recalibration may fit into one of three categories:

- ▶ Those conducting a broader strategic review of their investment business and capabilities, with the operating model as one key tenet
- ▶ Those proactively insourcing more asset management, with the operating model as the key tenet
- ▶ Those expanding their role in alternative asset classes, including attempting to replicate a direct investment model

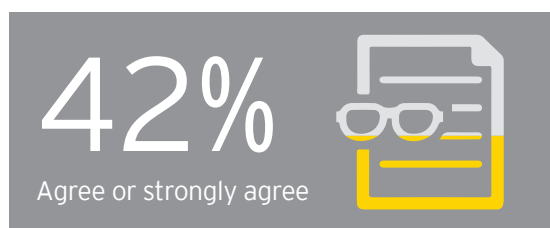
Respondents who disagree may be:

- ▶ Those who have an agile operating model or have finalized their evolution
- ▶ Those who use external service providers (asset managers and investment consultants) that are only in the early stages of transforming their investment operations for future growth
- ▶ Those who are widely sheltered from many of the disrupting trends for various reasons

EY point of view

We recommend conducting a systematic root-to-branch review. This shows stakeholders and members that organizations take their fiduciary responsibility seriously, and pinpoints their strategic and operational readiness to deliver sustainable investment outcomes. Review steps are similar across all organizations, but findings, decisions and actions will differ. EY's investment operating model development process provides a structured framework for a systematic and critical analysis. We expect the outcome of such a process will put organizations in a better position to deliver a sustainable, predictable and, transparent pension and retirement system.

Member and public scrutiny and fee pressure are driving insourcing



Almost half of respondents cite investment fee scrutiny as a contextual change and growing insourcing as an organizational response. Investment fee scrutiny has become a global phenomenon that varies considerably by country and is often driven by regulators, customers and local transparency practices.

Five aspects often are ignored by many external stakeholders in the insourcing debate:

1

Value for money. Higher fees are not necessarily indicative of poor value for money. Many high-performing managers and asset classes demand higher fees if they deliver substantially above expected investment outcomes.

2

Broader change. Insourcing of asset management requires a fundamental review of investment beliefs, strategy and asset allocation, and building additional capabilities and capacity.

3

Governance challenges. Insourcing of assets does not address investment governance or service provider weaknesses: poor long-term thinking, due diligence, selection, decision-making, oversight or tough exit decisions.

4

Getting out quickly. Existing mandates and partnerships require time to change. A common dilemma arises when high-performing mandates attract high fees and exhibit poor performance.

5

How to fire yourself: It is easy to replace underperforming external managers or mandates. But, how do organizations recognize and replace underperforming in-house managers, and solutions or asset classes?

Both scrutiny and insourcing require thorough analysis and preparation to sustainably and effectively respond. Focusing on fees only is too simplistic. Value for money and sustainability of long-term investment outcomes in members' best interest is paramount to systemically address the root causes. Leading providers, boards and stakeholders acknowledge that insourcing is a staged process that requires careful planning and communication and offers tremendous pitfalls.

EY point of view

We recommend that fundamental considerations to further insource – or outsource – investment management be conducted thoroughly. The insourcing decision must include: risk appetite and governance, aligning operating models to overall business and investment strategy, and building the necessary business and IT capabilities to support investment. A commonly neglected aspect in the insourcing debate: How can providers align their new investment and operational risk and risk appetite with that of their beneficiaries and relevant key stakeholders? Typically, beneficiaries expected external asset managers to deliver investment outcomes based on providers' selection and oversight. In the new world, providers are becoming "asset managers," often without historic track records.

Low returns and fees elevate pressure on cost to invest

76%

Agree or strongly agree



Providers say that the difficulty of delivering double-digit returns has increased significantly, but is not impossible – even today. Step changes in investment governance and fit-for-purpose capabilities and capacity are necessary to continue meeting providers' and beneficiaries' investment outcome expectations.

Have too many providers thrived on easy returns? Providers' focus on communicating fees and returns to stakeholders led to self-imposed commoditization of pension and retirement investment efforts. In a lower-return environment, communication must change. For many providers, the investment, liability or member administration and distribution functions operate in organizational silos. Below expectation investment returns not only impact investment outcomes, but liabilities and the ability to attract and retain members. Collaboration gaps impact long-term overall provider sustainability.

Three questions are important for all providers, their boards and trustees:

- ▶ Are we breaching our fiduciary responsibility by kicking the can down the road, maneuvering with unsustainable long-term return expectations or dramatically increasing investment risk without thorough consideration?
- ▶ What can we learn from peers who are still delivering attractive investment returns?
- ▶ How can we restore long-term sustainability of member and investment outcomes within a given risk appetite?

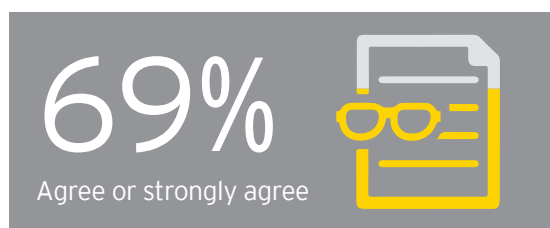


EY point of view

As providers adjust their outcome expectations in a lower-return environment, they must remain transparent with customers and clearly communicate return expectations. Scenario planning and stress testing the impact are pivotal to restore confidence and long-term sustainability. Answering the questions posed above must be based on a comprehensive and

thorough understanding of asset ownership costs, an explicit business and investment strategy and risk appetite, and a clear vision of how the provider delivers the expected long-term investment and beneficiary outcomes. Tough decisions may be necessary to ensure the financial well-being of millions.

Lower returns are driving more investment into alternative asset classes



More than two-thirds of respondents acknowledge that lower investment returns are driving a new breed of alternative asset classes. Providers are searching for additional sources of income and uncorrelated returns that extend much more to private equity, private debt, alternative credit, real estate and infrastructure.

Three levels of maturity emerge as pension and retirement organizations expand their alternative exposure at varying rates. A small number of providers have substantial exposure to these classes with in-house capabilities to deliver above expected returns. A larger number have modest alternative asset class exposure with dominant use of external managers and limited partnerships or separate accounts. Their goal is to replicate alternative asset class exposure, with a direct delivery model that follows the success of Canadian and Australian pension funds. And, a significant emerging group has limited alternative asset class exposure using only external managers. They have similar aspirations to the other groups, but struggle due to public and fee scrutiny, asset scale, risk appetite or simply policy restrictions.

Providers planning to expand their exposure to alternative asset classes may benefit from:

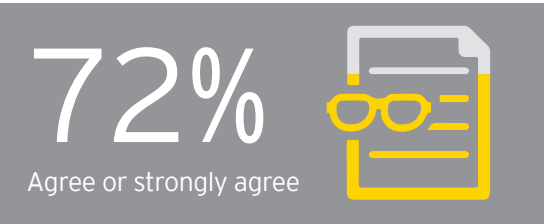
- 1 **Empowerment** to make strategic and operational investment decisions without political or other interference.
- 2 **Risk appetite** and enterprise risk management framework aligned with exposure to alternative assets and emerging risks.
- 3 **Board resilience** to defend investment decisions and support deals with global networks.

- 4 **Staff remuneration and incentives** to attract and retain the necessary professional staff to manage an alternative asset portfolio in-house or external managers and investees.
- 5 **Internal capacity and capability** to manage alternative assets in-house or via external managers across front, middle and back office.
- 6 **Stakeholder communication** with beneficiaries and other key stakeholders regarding increased risk appetite, fees and exposure from alternative investments.

EY point of view

Alternative asset classes are highly attractive for pension and retirement providers, many of whom are growing their businesses through traditional or insource managers or shared alternative models. In our view, alternative asset class exposure helps increase long-term investment outcomes and financial well-being. But, excess returns and a common longer investment horizon require excess risk appetite, vigilance, governance and organizational capabilities. Increasing alternative asset exposure may act as a catalyst for many providers to fundamentally transform their governance and organizations, as well as increase transparency within communications.

How scrutiny is challenging partner and outcome management



An industry that represents the largest institutional asset owner group, in excess of \$50 trillion in AUM, experiences the highest level of scrutiny from all stakeholders. Almost three-quarters of respondents acknowledge the challenges of increased stakeholder, regulatory and service provider scrutiny. They cite four underlying reasons why provider readiness is not aligned with new world requirements: investment governance and service provider maturity, operational due diligence and service provider oversight; organizational maturity and agility; and historically poor investment controls and capabilities.

Several questions emerge:

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Have members, beneficiaries and other stakeholders been negatively impacted by providers’ investment governance weaknesses or alignment gaps?

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Do providers sufficiently understand their fiduciary duties and expectations to act as professional managers of pension and retirement assets?

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Is current regulation aligned to new volatility and investment market and portfolio complexity?

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Are fiduciary responsibilities and expectations sufficiently clear, measureable and actionable to protect members and other stakeholders’ best interests?

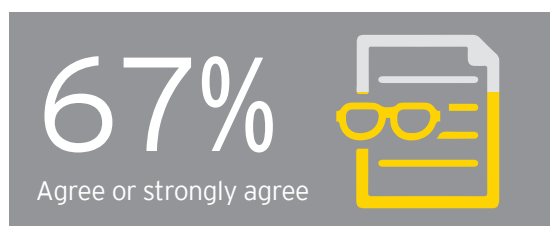
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The new world of pension and retirement providers creates higher expectations and the need for greater agility and more alignment.

EY point of view

Many providers rely heavily on an outsourced third-party delivery model. While boards or trustees can outsource their responsibility to deliver, accountability remains with the organization and board. Regulatory recognition of the outsourced model and built-in conflict of interest between members, providers and external commercial interests in many countries is crucial. We recommend that providers review their frameworks to manage service providers and investment managers, including controlling investments, offering clear service level arrangements and creating a board service provider committee to discharge obligations.

Technology is creating organizational challenges for providers



Two-thirds of respondents attribute their readiness gaps to technology.

- Their investment technology environment is not sufficiently mature to cope with the downstream impact of defined contribution systems and the shift to customer centricity.
- Many providers seem insufficiently prepared for the rapidly progressing convergence of pension, retirement and wealth management or using investment outcomes as a key competitive differentiator to attract members.
- The historic widespread silo structure of pension and retirement providers in investment functions, distribution and member administration is inadequate for the new world of member centricity, competition around investment returns and member choices.

The gaps become more prominent as providers move to further insourcing and expand into new asset classes. Rapidly increasing regulatory and compliance scrutiny, reporting and transparency create a platform for providers to swiftly and systematically close the gaps. These take the form of poor data quality or functionality restricted by underlying technology – impacting member trust and confidence.

Predictive analytics and first-generation FinTech and RegTech solutions are transforming the asset management space, leading to fundamental changes from blockchain, robotics, artificial intelligence and machine learning. Leading pension and retirement asset managers are considering these technologies to improve investment outcomes as part of their growth strategies.

EY point of view

Most providers embrace the importance of technology in the delivery of sustainable investment outcomes. But, policy and regulatory design and focus must align with the new world, too. This will more holistically set expectations and support sustainable delivery of investment and member outcomes. We recommend that providers develop a level of investment technology maturity that aligns to the new world. A sustainable, effective and efficient evolution must be based on long-term pension and retirement systems and reforms, investment strategies and operating models, as well as adequate technology architecture.



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Pension and retirement challenges pose a complex array of issues for governments, public and private sector organizations and their stakeholders. These challenges include social, economic, financial and delivery-related dimensions. They take the form of: a short-term focus, uneven political and economic realities and the globally widespread threat of defaulting on past fiduciary obligations. All serve to create a new need for a shared long-term vision, mission and strategy – as well as an efficient operating model.

At EY we serve public and private pension funds, pension providers in the insurance and asset management sectors, government policymakers, regulators and service providers. We focus on what we believe are the four key pension challenges: financial adequacy, investment performance and efficiency, financial sustainability and effectiveness of operations. We turn data and information into insights – to support improved predictability and outcomes.

Our cross-functional teams deploy domestic knowledge and overseas experience to address these issues. They help restore confidence that supports a better working world today for all stakeholders – and a more secure retirement for millions tomorrow.

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