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Technology outsourcing without giving away the farm

Asset managers have historically handed over back-office operations to asset servicers

By Thomas Grande, Navigant

It should come as a surprise to no one that the financial services industry is under a tremendous amount of regulatory pressure. Asset management and asset servicing firms are expected to continue to reduce overall costs while at the same time adhering to ever increasing reporting requirements on behalf of their clients. Providing more transparency to clients means additional cost and risk to asset management firms trying to protect their proprietary processes.

This all begs the question: How is it possible to introduce a myriad of new operational and compliance-related spending to the overall organizational structure in response to the changing regulatory environment, while at the same time reducing expenses and costs?

The Office of the Comptroller of the Currency and the Federal Reserve continue to put pressure on bank-owned service providers to improve their internal procedures and account setup processes. Specifically, many large bank-owned asset servicers have been required to spend years remediating client documentation and revamping both "know your customer" and "anti-money laundering" processes to adhere to ever changing regulations. Additionally, many of those providers have also implemented very costly changes from an operational and systemic standpoint with the goal of providing greater transparency to both the OCC and their clients.

Large bank asset servicers

The large asset servicing companies have been trying to increase fees in response to the changing regulatory environment and related, ever increasing cost pressure to do business. While fees have in fact dropped over the past two decades, margins are thin. In the past, the solution for this has been for companies to add scale in the form of more clients. More accounts and/or opportunities to cross-sell products to existing clients were viewed as a means to ensure every client relationship is reasonably profitable. Contrary to this approach, over the past three to five years we have seen asset servicing providers trying to create more centralized approaches to their business models and near-shoring many items that were initially being offshored. While offshoring proved to be a dramatic approach to overall cost savings, it proved to be quite challenging for many business functions.

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Several service providers are in the process of tiering clients to identify the size, breadth and complexity of the ideal clientele they want to serve. Primarily, these desirable clients tend to be large in scope and interested in multiple service offerings. This trend does tend to disenfranchise these companies from continuing to sell to and support mid- to small-size clients. While this approach certainly works well to reduce costs by minimizing the spending on relationships that have a lower margin and cross-selling opportunities, it also limits the ability of a firm to standardize its approach across clients or leverage their economies of scale by employing a pragmatic, easily scalable solution for smaller clients.

Investment managers and their proprietary front office

Historically, outsourcing and offshoring entire operations through liftouts and complicated conversions represented the more dramatic types of approaches to outsourcing. The definition of outsourcing means many different things to many different people and institutions, as it is a service concept that is very individualistic based on an investment manager's needs and client requirements. Investment managers were simply trying to provide respectable returns to their investors, and generally not concerned with what happens beyond the front office. To many in the front office, those functions only appear to get in the way of otherwise fruitful and mutually beneficial client

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relationships. Investment managers typically didn't care, they just wanted to manage money and enhance client returns.

What to learn from outsourcing history

The concept of investment managers outsourcing their middle- and back-office operations dates back to at least 2000, when Trust Company of the West awarded BNY Mellon (Mellon Financial at the time) a geographical outsourcing deal that encompassed a full liftout of both people and technology. The deal itself helped Mellon establish both a strong presence on the West Coast and critical scale in the market. This extreme approach to outsourcing, as investment managers quickly learned, did not necessarily translate to cost savings. Over the ensuing years, we have found that this tends to hold true when the outsourcing consists of a full liftout that involves people, technology and, in some cases, geography. State Street Bank later won Pacific Investment Management Co.'s middle- and back-office operations business as a means to break into the market, which also proved to be challenging, as the liftout didn't change anything on the surface except who ultimately paid the employees in the middle- and back-office operations teams.

We believe that complete outsourcing of middle- and/or back-office operations can still be successful in the right circumstances. For instance, asset servicers such as BNY Mellon, State Street, and Citibank have learned through the years how to create business models that work well for several investment managers. Other non-bank service providers, such as SS&C's GlobeOp division, offer a support model that gives the impression of leasing space on a mainframe. The bottom line is there are many case studies available that explain what not to do, but very few that advise on what to do when it comes to outsourcing.

Outsourcing landscape

The bank-owned service providers have tried to lead the outsourcing charge since back when "Y2K" was the biggest industry concern. After the 2008 market crisis, many technology firms materialized and then expanded to accommodate the outsourcing needs of the asset management community. At the same time, the bank-owned asset servicers shifted their focus to proactively addressing the increasing regulatory issues and remediating their businesses, which involved a tremendous effort to downsize the number of clients, while simultaneously trying to lift their earnings figures.

The increasing growth of more targeted, non-bank-owned technology service providers has come about because of the need to fill the products gaps left by the decreased focus of bank-owned asset servicing providers. In some cases, third-party service providers actually were born by talented individuals who decided to leave large bank-owned service providers to form their own firms, yielding quite a bit of success. Targeted technology efforts still are the best solutions to lowering risk and costs associated with security settlement process for all the players involved.

Our recommendation

Selective technology outsourcing (without giving away the farm!) is a great way to realize cost containment and still ensure that all regulatory obligations are met. Outsourcing should address the following concerns:

1. Transparency to clients and regulators
2. Operational risk
3. Adherence to regulations and compliance
4. Optimization of resources and human capital

We believe investment managers should consider targeting technology solutions and/or firms to which they can outsource in a manageable fashion. There are a number of leading-edge technology firms that have customized their businesses to specialize in certain asset classes and functions within these asset classes. For instance, we are working in a partnership with a firm that specializes in creating dashboards for investment managers that handle separately managed accounts — an incredibly focused and targeted problem they saw in the marketplace. Another firm we are working with focuses solely on a set of products that specialize in automating functions in the "40 Act" space, as it relates to fund expenses.

"Ad hoc" and "one-off" solutions were created with the best of intentions, but too often introduce increased costs and a great deal of risk. With that said, we strongly believe asset management firms should look at their manual and ad hoc processes, and identify the specific functions that appear primed for outsourcing. There are a number of firms that operate in an agency model, where they handle every aspect of a specific function. There are others that provide investment managers with the technology to do everything in-house, enabling the managers to protect their proprietary processes as well as fully realize their cost savings. In many circumstances, managers need to decide whether to expand their middle- and back-office operations to accommodate regulatory change or outsource specific functions. In addition, investment managers should ensure they understand their entire post-trade and execution model.

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