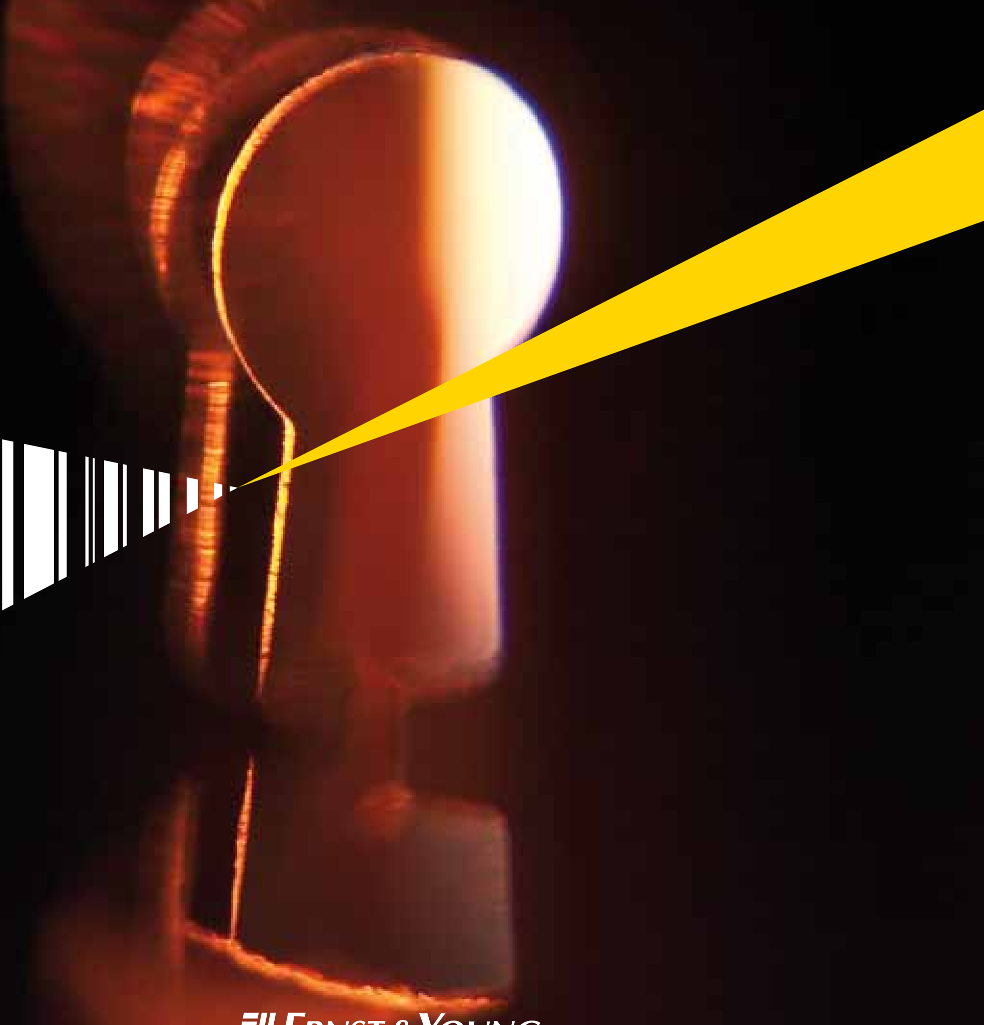
Viewpoint

Second generation outsourcing in the asset management industry

European Asset Management Viewpoint Series



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Second generation outsourcing in the asset management industry

In this paper, we explore outsourcing market development in the asset management industry, particularly in the area of middle office services. We examine the increasing desire of many firms to revisit their existing arrangements, the obstacles that are often seen as restricting mobility between providers and the emerging trend of asset managers being willing to overcome these barriers in order to change providers. We also highlight some of the steps service providers are taking to attract and retain business, as well as suggest areas of focus for asset managers seeking greater value through switching.

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Asset managers have a number of motivations to revisit their back and middle office outsourcing arrangements

Outsourcing is a key part of the European asset management landscape. There are few firms today that do not find themselves in some way dependent on a third party to carry out essential business functions. Continuing pressure on European asset managers' margins and revenues, combined with the growing costs of regulation and technology, means that many firms are once again reviewing their outsourcing relationships. They might consider extending their use of outsourcing, improving existing contracts or reducing the number of service providers. Apart from saving money, the most common motives are to improve scalability and speed to market of new products, eliminate duplication and free management to focus on core competencies.

As asset managers review their outsourcing arrangements, they are becoming increasingly interested in improving the value created by their use of middle office service providers. Middle office outsourcing is not new, and many firms have been relying on third-party support in this area for several years. However, as service providers broaden their range of middle office capabilities, achieve greater economies of scale and improve the reliability of existing services, there is increasing scope for asset managers to revisit their arrangements.

While changing custodians is commonplace and switching between fund accounting providers – although far from easy – is not unusual, asset managers rarely move their middle office outsourcing. In fact, many previous attempts have resulted simply in renegotiation of fees. Second generation outsourcing describes an emerging trend for asset managers to consider such a change and, in a small number of instances, execute upon this.

Why is this? To find out, we analyzed asset managers' motives for switching between service providers and the potential barriers to change. We also look at steps being taken by asset servicers and their clients to increase the potential benefits of outsourcing.

European asset managers have the motive and opportunity to switch between middle office providers

Apart from improvements on the supply side, there are a number of reasons for asset managers to focus on improving their existing middle office outsourcing arrangements:

- **Service-related factors.** A significant minority of asset managers feel they have been let down by the quality and consistency of service they have received from their current service providers.
- **Practical considerations.** Mergers and acquisitions among both asset managers and asset servicers have left some firms with a complex web of outsourcing relationships. Asset managers see an opportunity to reduce inefficiencies of scale, duplication and oversight by reducing their number of outsourcing partners. Asset managers that are part of larger banking or insurance groups may also come under pressure to use service providers already working with other parts of their organization.
- **Contract renewal.** Many outsourcing agreements entered into early in the last decade are coming to an end, and principles of good governance require that these should be reviewed to establish whether improved commercial arrangements or services are available. This gives asset managers a window of opportunity to switch between service providers without incurring expensive penalties for early termination.

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However, the barriers to changing middle office outsourcing arrangements remain significant

Despite these motivations and the potential benefits of switching in terms of operational efficiency and management time, few asset managers are ready to move between middle office providers. This reluctance reflects a range of perceived obstacles, which are commonly seen as making switching a difficult or risky process.

The first and most obvious factor is transition risk. To change middle office outsourcing providers can easily take 18 months from start to finish, while pulling significant resource from business-as-usual activities. At a time of market volatility, many firms are particularly wary of the potential for operational errors in the period leading up to, during and after a transition, creating interruptions in service and possible exposure to reputational risk.

Untangling the complex connections between the operating models of an asset manager and its service provider involves a high financial cost (some of which may be covered by the incoming provider) and a significant drain on management time and attention. This issue not only dissuades asset managers from attempting to switch service providers but also raises the question of whether asset managers have adequate contingency plans in place should a key provider of operational services fail.

Another problem is that once firms have outsourced a particular activity, they can find it hard to clearly define their requirements of a new provider and conduct due diligence. This reflects a lack of detailed knowledge of the activities conducted by the outsource provider, which becomes increasingly problematic as time goes by and regulatory or customer requirements change.

Finally, employment rules that protect employee rights during outsourcing can act as a disincentive for asset managers to switch between service providers. In the UK these are known as TUPE rules, but there are equivalent regulations in some other EU states. TUPE rules mean that a new provider taking over an outsourcing contract will probably need to offer similar work or unemployment benefits to some employees of the old provider. This adds to the overall costs of switching and means that even when asset managers switch service providers, they may end up working with the same team as before.

These factors, combined with a perceived lack of differentiation between service providers, can encourage a "better the devil you know" mentality that shies away from the potential difficulties of switching.

In response, outsourcing providers are going to new lengths to attract and retain business

In addition to these hurdles, the economics of middle office outsourcing can act as a barrier to mobility. So far, middle office outsourcing has not been a very profitable activity for most providers. Many have grown these activities by lifting out clients' systems and processes in their entirety, sometimes leading to highly tailored services and sometimes duplication. The required skills have also proved to be more varied than for back office outsourcing, with a greater need for daily contact with the front office and a significant diversity of activities.

These factors have kept costs stubbornly high, and many service providers have struggled to deliver the efficiency gains they have achieved for back office operations. This has left them increasingly unable to offer the kind of fee discounts that many asset managers are hoping for.

In terms of retaining existing business, incumbent service providers are investing to improve the quality and consistency of their existing services, expand the range of services they offer and enhance their relationship management skills. Improving clients' ability to communicate with their own employees at every level of seniority is another area of focus. Some incumbent providers have also been willing to offer significant discounts to existing customers to retain business.

Service providers seeking new middle office outsourcing contracts are also going further in the search for new mandates. One major step that some are now willing to take is to provide middle office services on a stand-alone basis, despite the challenging economics. The longer-term goal, implicit or explicit, is to win more lucrative back office contracts that will boost the profitability of the client relationship.

Given the difficulties and costs of shifting from one service provider to another, outsourcing providers are developing their transition management capabilities. In a number of cases, they have made up-front payments to asset managers to defray the costs of transition.

Preparation is vital for asset managers hoping to get the most out of second generation outsourcing

What can asset managers do to make sure they are well-prepared for second generation outsourcing? Based on our experience, we recommend several preparatory steps that firms contemplating a change of outsourcing arrangements should consider.

Before the selection process begins, asset managers can take a number of practical steps to help ease the process of transition between outsourcing providers. These include monitoring the changing requirements of the business and keeping the details of service level agreements under constant review. This is crucial to understanding not just how well current providers are performing, but also how they are delivering service outcomes. At an organizational level, asset managers who have structured their operating models to be independent of any service provider through the creation of a data isolation layer will be well placed to reduce the disruption of changing middle office provider.

During the selection of a new provider, speedy decision-making focused on predetermined key differentiators among service providers will accelerate the process and reduce the overall costs of transition. Being prepared to bundle middle office functions with other outsourcing mandates will also encourage providers to offer the most attractive terms. Asset managers should make sure that their new provider is sharing the costs and risks of transition, too. A phased transition is likely to require less preparatory work and carry less risk.

Firms will also need to commit time and capital to the implementation of a middle office contract if they are to realize greater value from a new outsourcing relationship. Poor relationships with service providers are unlikely to generate the value that should flow from good communication and coordinated working practices.

Is second generation outsourcing an emerging trend?

Asset management firms' desire to improve the quality of their middle office functions is increasing. So too are the capabilities on offer from outsourcing providers, as well as those providers' willingness to offer incentives. Even so, the impetus to switch is still often outweighed by the costs and potential risks involved.

However, we have seen signs that this situation is changing. A small number of asset managers have been willing to commit to a switch of middle office provider, with a few transitions already completed successfully. As asset managers continue to enhance their readiness and ability to switch and providers make further developments in their services and in the transition support they offer, the complexity of switching between providers will continue to fall. As a result, we expect moves between middle office service providers to become an increasingly common feature of the asset management market.

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