FUND OUTSOURCING 2013

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Expanding the middle office footprint

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Operations outsourcing climbs the value chain

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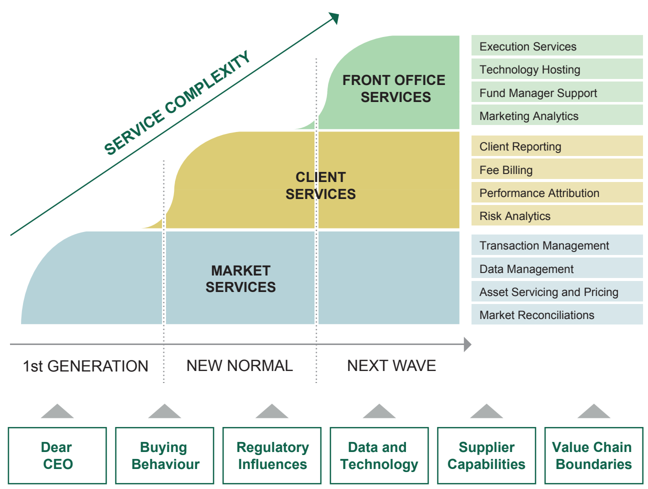
Northern Trust's Les Beale and Terri van Praagh explore the growing trend to outsource middle-office investment operations, the next stage of evolution and the key decision criteria to enable a successful outsourcing relationship.

Outsourcing is on the move again and the industry is preparing itself for another surge in activity. Beale and van Praagh identify six critical drivers behind the increased appetite for outsourcing among asset managers and asset owners, which in turn are driving providers to expand their capabilities to support front and middle-office activity (see figure 1).

Figure 1



1. 'Dear CEO' - increasing focus on risk management

In December 2012, the Financial Services Authority in the UK (now the Financial Conduct Authority, or FCA) sent a letter to the heads of the largest asset managers in the UK outlining concerns over levels of oversight on outsourcing arrangements and the robustness of contingency plans. Taking an active stance, the industry responded with the formation of an Outsourcing Working Group (OWG), which is addressing three areas: standardisation, oversight and exit planning.

An area of concern for the FCA is the time it takes to move between providers (anything up to 24 months); according to van Praagh, a member of the OWG, this lag stems from the differences in platforms and operating models.

Consequently, one of the OWG's key areas of focus is on developing communication and data standards to reduce this cycle, along with good governance and appropriate planning. The OWG's task is undoubtedly difficult, as of course one organisation's standard may be another's bespoke practice – but the outcome will ultimately improve market practice and increase confidence in middle-office outsourcing.

2. Buying behaviour – the expanding arena

Outsourcing has occurred at a varying pace for different buy-side participants. The asset manager model is well established and the operating environment so mature that many arrangements are now considered 'second generation relationships'.

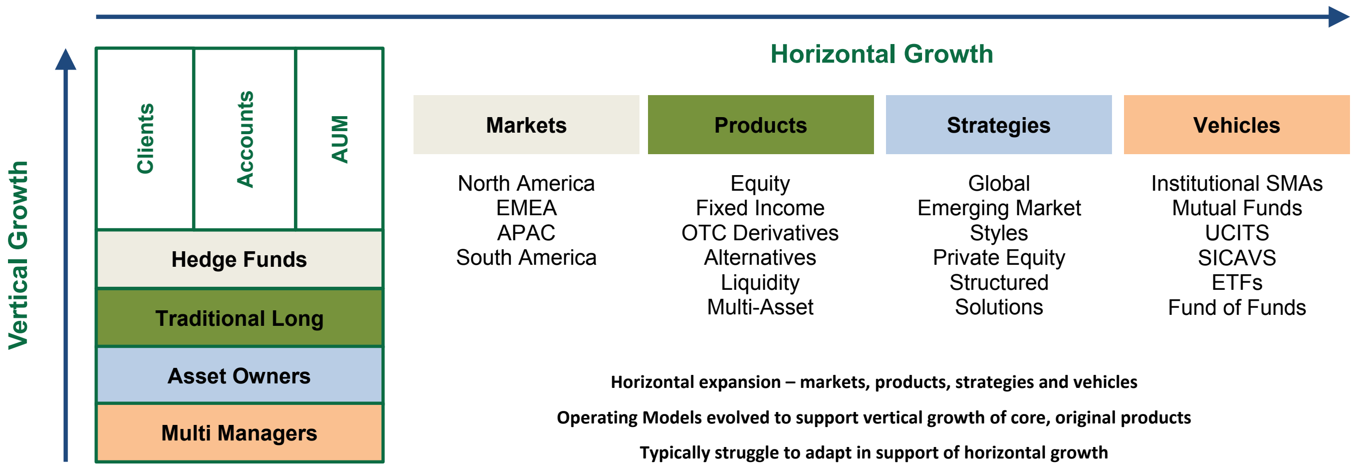
For asset owners: the self-managed pension funds, sovereign wealth funds and insurance companies, the maturity level is less pronounced. However, as they seek greater efficiencies by moving more of their portfolios in-house, interest in outsourcing is increasing.

van Praagh believes that the rationale for outsourcing has evolved from being a mainly cost-driven exercise, with clients now needing to enhance their operations to accommodate expansion into new markets, asset classes and investment strategies (see figure 2).

"Northern Trust has found that access to established services and platforms is particularly attractive to asset owners that are moving from a multi-manager model to a self-managed or hybrid approach," says Beale. "Such moves require re-engineering and a mind-set similar to that of a start-up, where the main objective is to limit the amount of infrastructure used in-house."

A recent example of this can be seen at newly-formed investment management company Cameron Hume. According to Chris Torkington, Director at Cameron Hume:

Figure 2



"As a start-up, we took the decision to outsource operational functions in order to fully focus on our strategy and core competencies as a niche provider of fixed income investment management services. It was therefore important that the outsource provider had sufficient capability and flexibility not only to provide us with speed-to-market at a critical growth phase, but also to scale in line with our future development. Leveraging Northern Trust's established infrastructure, expertise and products will enable us to manage and develop our business while delivering the highest levels of service to our clients."

3. Regulatory influence - increasing administrative burden

With the current wave of global regulation continuing apace, asset managers and owners are challenged to comply with increasing amounts of administration due to regulators' and investors' demands for more transparent and detailed reporting. In order for managers to concentrate on what they see as their core competencies, they are turning to outsourcing providers for assistance.

Moving to a platform which can accommodate regulatory change such as FATCA and EMIR, is an increasingly attractive proposition for managers says van Praagh. Blue Sky Group, a Dutch fiduciary manager, turned to Northern Trust to help them achieve good governance and transparency around their collateral management process. Remco Jacobs, its Head of Middle Office explains:

"Blue Sky works with multiple clients with multiple overlay programmes. As our internal collateral process was faced with increasingly high volumes, we took the decision to leverage the breadth and scale of Northern Trust's active collateral management capabilities. Outsourcing the entire process - including daily independent valuations, counterparty exposure calculation and managing the full margin lifecycle - to an independent provider, has enabled us to increase our focus on oversight, whilst avoiding stretching capacity from a personnel and systems perspective."

Beale and van Praagh believe Blue Sky are not alone in this space and expect more clients to look to their providers to solve the impact of regulatory change.

4. Data and technology – taking centre stage

The treatment of data lies at the heart of the mature outsourcing model and forms a critical part of the industry's focus on governance and transparency. "The ability to access timely and accurate aggregated data, which can be sliced, diced and integrated within a manager's organisation, is a key driver behind an provider's success in expanding its middle-office outsourcing footprint," says Beale.

"Here, the investment book of record is a concept much in demand among asset managers because it gives the front-office an aggregated view of data that they can use for investment, compliance, audit and reporting purposes. In-house architectures are often complex and expensive to maintain and having the ability to future-proof technology has also increased the appetite to outsource."

The emergence of ''big data", a term being used increasingly to identify trends and potential investment opportunities, has led to the need to develop solutions incorporating structured and unstructured data. "Service providers such as Northern Trust are adept at aggregating, analysing and distributing data, and will need to continue developing their products to meet the needs of existing and future clients", notes Beale.

5. Supplier capability – critical success factors

In Beale's opinion, the ability to meet increases in client demand will be dependent on sustained development of the outsourcing model and the ability to support the following client objectives:

- Globalisation of asset managers
- Merger and acquisition activity
- Convergence of traditional long only and hedge fund strategies
- Reducing internal infrastructure costs, future proofing technology spend
- Execution and fund manager analytical data
- Enhanced data access to support governance and transparency requirements
- Increasing demands in change management driven by distribution and performance

"Ultimately outsourcing is about comfort, choice and flexibility" says van Praagh, "and today's offerings accommodate the varied approaches taken by firms. At one end of the spectrum lies component-based outsourcing, where firms are able to choose specific functions. At the other is the appointment of 'shadow administrators' where one administrator performs standard administration services and another performs the same work independently, providing an additional layer of oversight, control and resiliency."

6. Moving up the value chain - where next for suppliers?

Client reporting is a prime example of an evolving service once considered a key customer-facing responsibility. Many managers are now happy to use a white-labelled service to provide, not just the underlying calculations, but actual report delivery. For example, Northern Trust provides a white-labelled monthly valuation and quarterly investment report used by more than 80% of its outsourcing clients.

This change in attitude has required the development of capabilities in the middle-office outsourcing world to flourish. Northern Trust also includes performance attribution, risk management and fee-billing in its middle-office offerings; what was formerly the domain of the asset manager is now accepted as the "new normal" in the outsourcing space.

As asset managers continue to hone the definition of what constitutes "core competency", new opportunities are arising in the front-office space, including commission recapture reporting, transaction cost analysis, technology hosting and execution services. Providers are stepping into this space and developing solutions enabling them to grow their business both horizontally across the functions, and vertically using their scale and global footprint.

Beale concludes: "Trust, strategic alignment and culture are all key to successful outsourcing relationships, but this must be backed by robust service provision, flexibility around change and open communication.

"All the indicators suggest we are now heading for the next wave of outsourcing. In this environment, the ability for providers to move up the value chain – and the agility at which they manage this – will become a key differentiator."

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This article is extracted from the "Fund Outsourcing" report by Clear Path Analysis, published September 2013