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The Algebra of Oversight

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Outsourcing to a service provider could remove a lot of operational responsibility from an asset manager's plate, but it introduces a new obligation—the oversight of the service provider.

Oversight could fall anywhere on the spectrum from no oversight whatsoever (perhaps a little too trusting) to a full shadow (perhaps not efficient). The question some asset managers face is: where should they fall on this spectrum?

This is a very difficult question to answer as each function, asset manager and service provider is different. However, this paper breaks down the inputs to this consideration to help asset managers think through the process of determining the right level of oversight.

When was the last time you took a good look at your service provider oversight program? When was the last time you gave algebra any thought? Maybe it's time to think about them both at the same time.

Whether designing a new oversight program or re-evaluating an existing one, asset managers could be faced with several specific questions:

- What should be done to mitigate risk?
- How should the relationship be managed?
- How many resources will it take and how do we justify committing these resources?

Asset managers want to prevent errors and improve service levels. Since an oversight program can achieve both goals, how does an asset manager quantify and justify the investment required for an effective program? In theory, the answer is — the level of investment should be driven by the value the oversight program creates.

Let's start with a simple algebraic formula. The following is a proposed formula that can be leveraged to help identify the value created, and thus justify the investment in an oversight program.

$$(A + B) * C = D$$

Where:

A = Value of avoiding errors

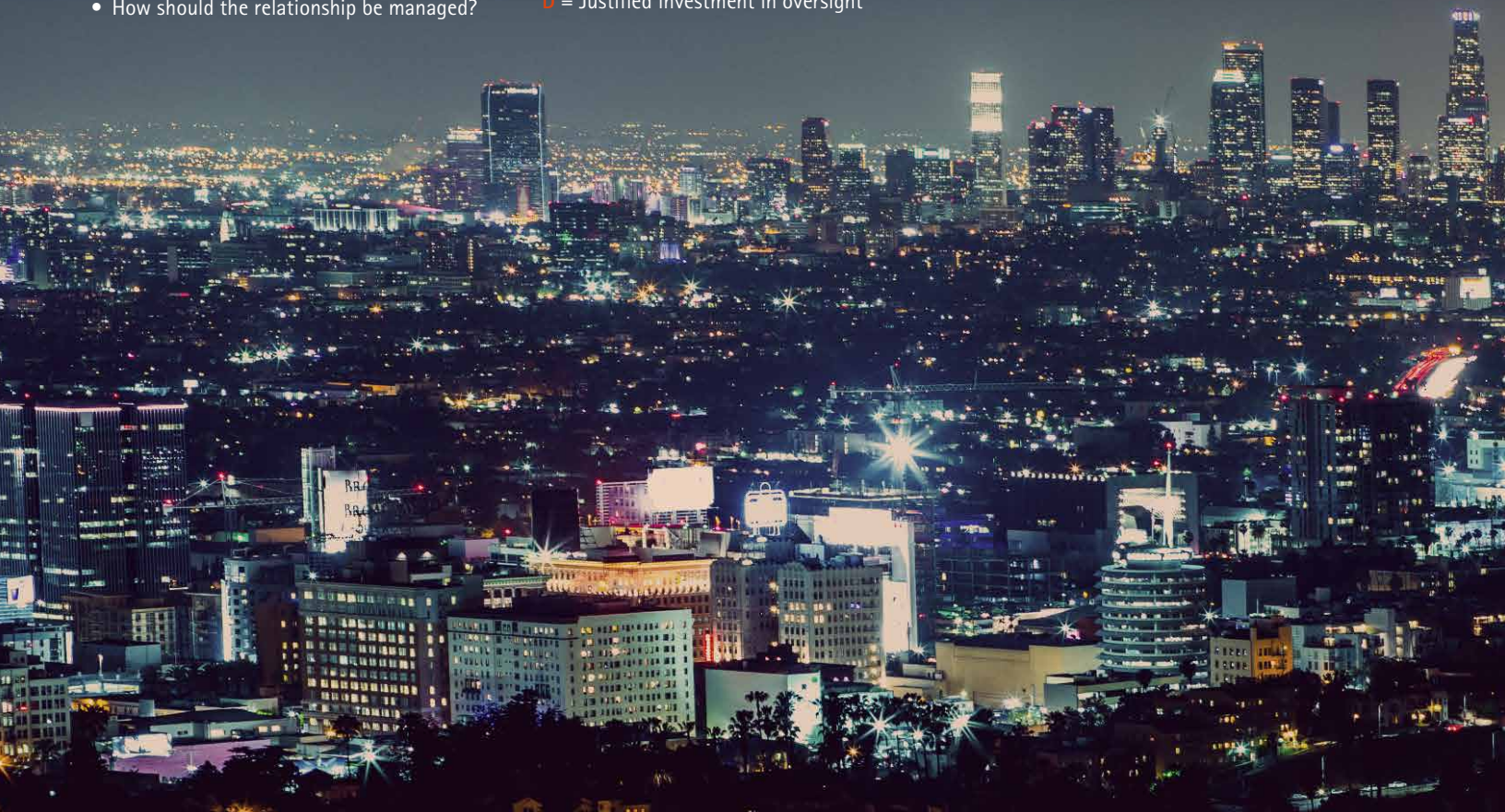
B = Benefits of achieving and maintaining service level quality

C = Probability of accomplishing A and B with your oversight program

D = Justified investment in oversight

Theoretically, if the value of avoiding errors (A) was added to the benefit of achieving service quality (B), then multiplied by the probability of success (C), the result could be the justification for investment in oversight (D).

Obviously, any formula is only as good as the quality of its inputs. While the inputs into the formula may be interpreted and defined differently, or more theoretical in nature, it is the act of working through the thought exercise that could provide the highest value. This process could lead to a meaningful discussion with management to confirm they are on the same page with shaping an oversight program.



A) Value of Avoiding Errors

To determine the value of avoiding errors, the errors worth avoiding should be identified. The first step in this process is determining, from a business standpoint, the critical risks that are exposed through the specific outsourced function. Eliminating all risk is unrealistic, so one should determine which risks are most consequential and can realistically be mitigated. Consideration is often given to risks such as regulatory, reputational, financial, etc. This exercise requires input from all levels of management and should leverage past experiences while also accounting for future demands.

The next step is identifying the production and operational errors that could give rise to those risks such as: Net Asset Valuation (NAV) errors, incorrect distribution amounts, missed regulatory filing deadlines, faulty expense ratios, missed trades, etc. The last step is placing a value on avoiding these errors. This is a theoretical exercise that is subjective and will differ across asset managers. It must be subjective because the value ascribed to avoiding each error type is not always numeric and could vary by asset manager as each might have a different assessment of risk and a different set of priorities. The overall result of defining Input (A) is understanding how each risk point could cause the greatest negative impact in the asset manager's view.

B) Benefits of Achieving and Maintaining Service Level Quality

One of the goals of service provider clients is to receive high quality service levels. Believing these could be achieved simply because you told the service provider "you expect them" is unlikely to be effective. A better approach is a well-designed and implemented oversight program that maximizes the relationship to confirm both parties are aligned in a manner where high service levels are a logical outcome.

Historically, oversight programs have primarily focused on identifying and avoiding operational errors. While important, this approach only captures a portion of the value available from an oversight program. Adding vendor and service level management to the review activities can create a properly balanced oversight program. Vendor management activities include senior management from both parties to help confirm the approach and commitment of the service providers are as expected. Service level management involves measuring and reporting on key qualitative and quantitative aspects of the service provider's offerings on a regular basis. Monitoring trends such as responsiveness, proactive thinking and partnership relations can promote consistent servicing. When combined in proper balance with Key Performance Indicators (KPIs), these activities could collectively go a long way toward achieving service quality.

Placing a value on high quality service levels is again a theoretical exercise that is subjective and will vary by asset manager for the same reasons discussed for Input (A). But, clearly there is observed value in areas such as reduced risk, efficiency in internal operations, speed to market, timely reporting, industry insight and regulatory support.

C) Probability of Success

The third variable in the formula is the probability that the oversight program could realize the values of Inputs (A) and (B). Achieving the value is not guaranteed, as no program would be able to anticipate, prevent and detect every possible error. However, the probability of success can be increased dramatically by the quality of the program's design and the effectiveness of its execution. Implementing targeted checks supported by documented procedures and tools increases the likelihood of success, as does increasing the number of dedicated resources. A sound program stems from a thorough assessment of risk (potential and historical) that helps define oversight and vendor management activities which, when properly executed, are specifically intended to mitigate those risks.

No program is foolproof and thus the probability of success will be less than 100%. Assessing the likelihood will be driven by the nature of the identified risks, the extent to which mitigating activities can be targeted at those risks, and the level of tools and resources committed.

This is where the standard formula may help. Even if it is more theoretical and thought provoking than mathematical, it can still highlight key principles related to building an oversight program. For example, adding resources to the oversight program would not impact Input (A) or (B), but may impact Input (C). Utilizing the formula to guide a thought process, could show that each additional resource added could act to increase the justified investment in oversight. However, keep in mind there is a ceiling to the probability of success where diminishing returns result from the addition of resources. Overall, in going through the exercise of identifying the business risks, attaching a value to avoiding those risks, then designing an oversight program with a high probability of mitigating those risks, the business case may build itself.

D) Justified Investment in Oversight

The business case for outsourcing can be complex. Understanding the resource and technology savings resulting from migrating to a service provider can be difficult to predict, even before trying to understand the in-house staff that must remain for oversight. Allocating resources to an oversight program is not always an easy sell. No one enjoys requesting, let alone campaigning, for resources whose desired result is that nothing tangible happens (i.e. errors and service issues do not occur). Further, it's difficult to prove that an outcome of low errors and good service was attributable to oversight efforts. It's always hard to prove a negative. The good results may have happened anyway (because "you expect them"), but hedging your bet with a sensible level of oversight could increase the probability of those good results. The challenge is determining what a sensible level is, then making the business case for the resource expenditure to achieve it.

In Summary

When working through the formula above, the attempt to make qualitative estimates of where the inputs lie is the goal of the thought exercise. The most important part of the exercise may be understanding how the oversight program fits within the company's risk appetite. Some risk averse asset managers may attach a higher value to avoiding errors, and thus be willing to allocate extra resources to confirm the risk of error is mitigated to the highest degree. Others may accept a higher level of risk and aim to minimize overhead by instituting a lean oversight program.

There is no single, correct program that spans across the industry, but instead the main goal is to design a program that reduces risk to a level asset managers can live with on a day-to-day basis. As there is no silver bullet, it is important to build on the experiences of those within and external to your organization to understand the best principles and methods for building an oversight model that succeeds for your organization.

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