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Looking Beyond Cost When Assessing Middle Office Outsourcing

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What was once an exercise to reduce cost is now an opportunity for growth. Outsourcing, a trend which started with the asset manager's back office, has now shifted to the middle office. Many asset managers see outsourcing the middle office as a transformational opportunity to better position themselves for a changing investment environment rather than a pure initiative to reduce cost. In fact, outsourcing middle office functions could increase cost for some asset managers. Market pressures such as expanding regulations, shortening settlement periods, product expansion, and esoteric investment strategies have put strain on the infrastructure of asset managers. As a result, asset managers have been taking a serious look at whether or not outsourcing is the right fit. Given the critical role of the middle office in the investment lifecycle, assessing the viability to outsource these functions goes beyond cost.

The Tradeoff of Risk

A frequently asked question when conducting a current state assessment is, "what keeps you up at night?" The answer naturally gravitates toward risk. Though managing risk can never be outsourced, an asset manager's exposure to business, regulatory, and financial risk can be mitigated through an outsourced solution. Service providers will assume the responsibility for the quality of the functions outsourced and will be accountable for respective errors. But there is a tradeoff as asset managers will now inherit risk due to the relationship and reduction in control. Service providers, to some capacity, will become an extension of the asset manager as the asset manager will become dependent on its providers to effectively manage its level of exposure to service degradation and business continuity. This risk runs the gamut from poor service due to employee turnover to technology, disaster recovery, and beyond. High risk areas such as cyber security demonstrate the impact service providers can have on asset managers. In theory, the service provider should be well setup to minimize most associated risks as interactions with other clients would have demanded it, but that cannot be assumed. As a result, due diligence and continued assessment of high-risk areas must be factored into the assessment of an outsourced middle office solution.

Focus of Management

In the asset management industry if you are standing still you are moving backwards – a paradox yes, but still true. It is imperative for senior management to be focused on revenue-centric initiatives such as mergers and acquisitions, product launches, investment strategies, and distribution. A well-oiled operating model requires strong leadership and an accurate industry perspective. Asset managers who have explored outsourcing, back office and now middle office, have been able to shift their focus and energy to their core competency of managing money.

An outsourced solution alleviates the administrative overhead and the operational headaches; however, it is never as simple as "set it and forget it." Yes, the operational responsibility has been outsourced, but the overall fiduciary responsibility will always remain with the asset manager. An outsourced operating model requires a defined vendor oversight program to govern risk-based activities and the ongoing vendor management which is all supported by staff with the appropriate skillsets. The proper oversight program must be well articulated as the cost to oversee the service providers must be incorporated into the decision of whether or not to outsource. Experienced analytical resources must also be trained in their new role of "reviewer," a potential shift from the historic role of "preparer." The pinnacle of the oversight program resides with senior and executive management who are responsible for managing the relationship with service providers to ensure consistent quality servicing.

Key Stakeholder Impacts

Seeking alpha is the name of the game for portfolio managers. The front office is continuously looking for a competitive advantage over its peers. To support front office demands, it is crucial to have the proper operating model in place. An outsourced middle office solution can offer advantages to that end. Partnering with service providers can provide instant capabilities with access to markets that can be costly and time-consuming to implement internally.

Yet, it is not always about what the service provider can offer rather how the partnership will align with the needs of the asset manager over time. The requirements of key stakeholders vary and each organization must understand how outsourcing would impact its internal users. This is not limited to portfolio managers as areas such as risk, compliance, and performance among others could be impacted. The current operating model should be documented and compared to solutions offered by service providers. This makes it easier to analyze which additional capabilities and which compromises would come along with the outsourcing relationship as both are key drivers behind the final decision. Quite often the success of middle office outsourcing partnerships is dependent on the development of a target operating model that is mutually beneficial for both parties.

Technology and Data Footprints

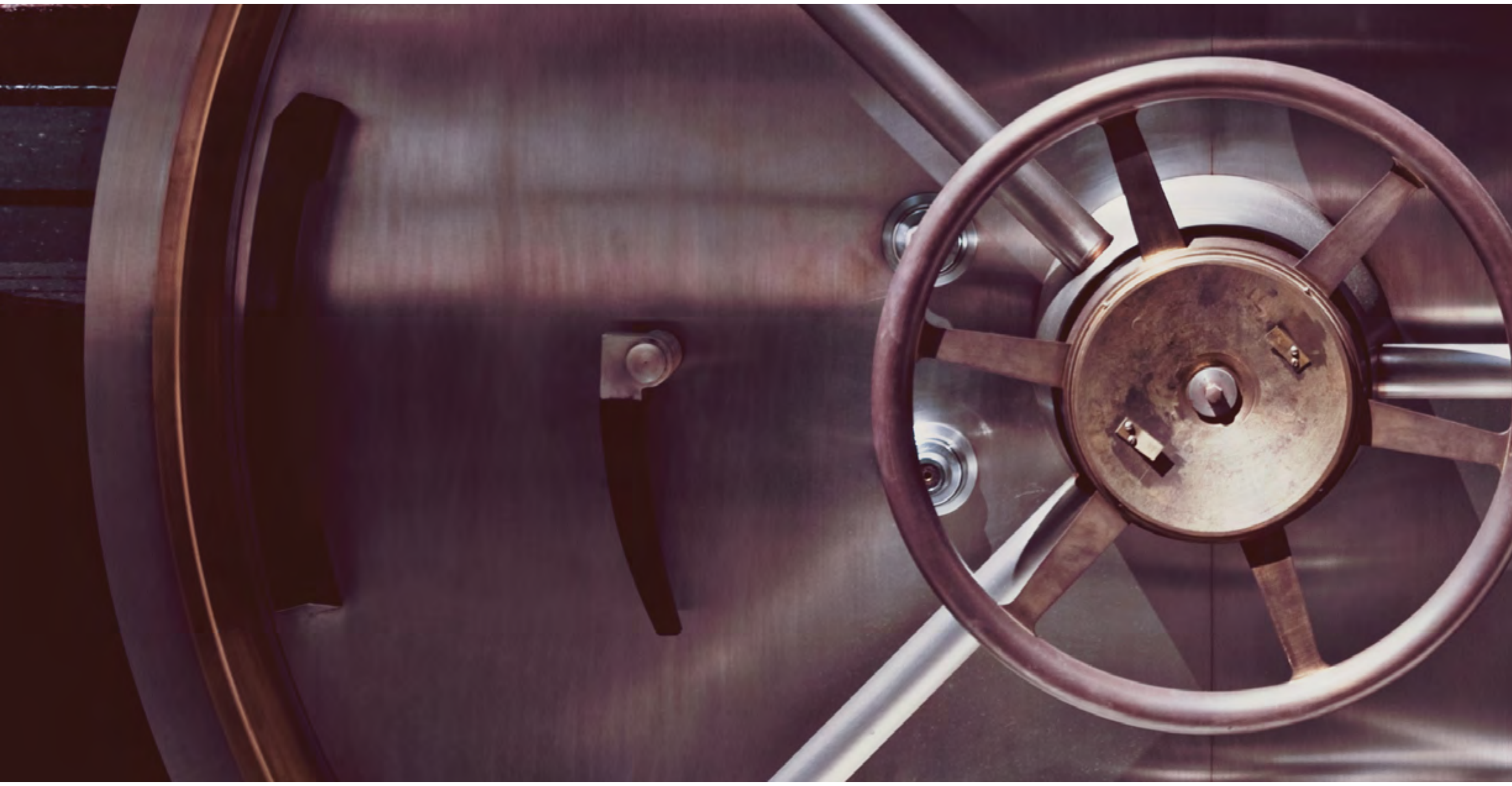
Constant stress has been put on technology as the front office continues to seek new investment opportunities and strategies. This pressure, accompanied with changing regulations and tighter budgets, has left the middle and back offices scrambling to meet the needs of the organization, often through work-arounds and offline processing. Outsourcing middle office functions can lessen these technology burdens. However, integration between the client and its service providers is a critical success factor. As the infrastructure is built between the two entities, it is important to align on long-term objectives.

A key role of the middle office is to provide consolidated and normalized data throughout the organization. Along with the front office, departments such as compliance, marketing, and risk all depend on the middle office to obtain enterprise-wide data. This is where a tailored middle office solution can support internal functions to drive the bottom line. An effective data governance plan accompanied with technology implementations and/or an outsourced solution can help facilitate the needs throughout the organization.

Asset managers can certainly benefit from leveraging the technology capabilities of service providers for enhanced quality and reduction in internal investment; though, asset managers should consider how this fits across an enterprise-wide solution. It is important to consider which products or investment types will be outsourced versus which will remain in-house and what type of maintenance will be required to normalize across the platforms. Outsourcing is never as simple as handing over the operational reins and throwing the technology over the fence. Proper infrastructure is required to consume and normalize the data. Nailing this part is key to maximize the service provider's capabilities which is essential to making the partnership work. As such defining, communicating, and agreeing on a proper data governance model are the glue between the two entities and are critical to reach success.

Conclusion

There is no universal answer to the question of whether or not to outsource a function as no two asset managers are the same. An asset manager should continuously be evaluating its operating model to ensure it aligns with anticipated challenges and growth. When outsourcing is a consideration, assessing the financial elements of the decision can be the most straightforward. However, evaluating qualitative elements can be even more impactful.



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