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INSIDE OPS

ASSET MANAGERS: PLANNING FOR CONTINGENCIES WITH OUTSOURCING PARTNERS

INSIGHTS FOR OPERATIONS LEADERS IN ASSET MANAGEMENT

When asset managers outsource a function to a service provider, they place a large amount of trust on the selected partner to perform its promised duties. But what happens if the service provider encounters a "doomsday" scenario? Say the service provider notifies the asset manager one Tuesday at 4pm that it will be unable to calculate the net asset value (NAV) for an indefinite period of time?

A plan should be in place to limit the risk of such occurrences and as a framework of what actions need to be taken if one does occur.

Exposure to such a risk is most important in a commonly-outsourced function: back-office accounting. The complexity of calculating NAVs and the tightness and frequency of the providers' deadlines all magnify the challenges. One cannot entirely avoid the risk of a problem occurring with a service provider, but there are ways to mitigate potential disasters.

FIRST LINE OF DEFENSE

The first line of defense against a doomsday scenario is the outsource provider's disaster recovery plan. Not all major risks can be defined ahead of time, but a good contingency plan will attempt to foresee all potential risky scenarios and define how the company plans to respond in each situation. The asset manager should review its partner's disaster recovery plan as it is a critical part of the upfront and annual due diligence processes. Furthermore, the service provider's disaster recovery plan becomes an extension of the asset manager's plan. This makes it even more important to involve both IT and business resources in the review. Common test scenarios include recoveries from technology downtime, major blackouts, cyber-attacks and significant facility events.

However, it is not enough to simply identify backup technology, locations and resources. The provider should also prove the ability to truly produce all deliverables in these environments.

Reviewing the service provider's disaster recovery plan can help asset managers gain comfort early in the relationship. However, there may be other ways asset managers could internally mitigate the risk of a disaster throughout the relationship.

LEVERAGING MULTIPLE PARTNERS

Building in redundancies by having relationships with multiple service providers is another technique used to avoid a doomsday scenario. It can be accomplished by splitting one book of business or different product types across more than one provider. The immediate upshot of this strategy is that if one service provider suffers an outage, not all funds would be impacted. It would open the door for thorough planning of how one service provider could step in and take over the responsibilities of its counterpart if there was a longer-term need. Leveraging multiple service providers is not common in the mutual fund industry today, but its popularity has increased with the need to diversify. This is a similar concept to the way asset managers manage exposure to custodians.

However, there is also significant setup required for individual funds either upfront or afterwards as the second provider requires time to step in and take on additional responsibilities. Therefore, this is not an adequate immediate disaster recovery option. Instead, it is more of a long-term remediation if a service provider cannot recover. Nevertheless, the benefits of this option would need to be weighed against the accompanying higher costs and initial set up times, along with potential legal implications.

FULL SHADOW

One way we have seen asset managers try to internally mitigate against a disaster scenario is to complete a full shadow accounting of the outsourced processes. A full shadow consists of performing all activities needed to complete the service provider's deliverables, including NAV calculation and dissemination, while also reconciling to their deliverables. Full shadow accounting would put the asset manager in a position to immediately step in and take over if needed. Cost aside, this seems like an ideal solution. However, the asset manager would incur large ongoing costs for a slim possibility the actual disaster scenario occurs. For this reason, a full shadow is not an option that we typically recommend.

USING THE OVERSIGHT MODEL

If a full service-provider shadow is equivalent to towing along an extra car on a road trip, a flexible oversight model is akin to bringing along a spare tire. Oversight models are cost effective ways to review service provider deliverables on a day-to-day basis. However, they do not set the asset manager up as well in the event of a service provider's failure. A sound oversight model is often limited to a risk-based review of key service areas, as opposed to the full completion of the processes. It may be possible to use the oversight resources to patch together required deliverables in the short term during a provider's downtime—assuming the resources have access to the required data.

CONSIDERING YOUR IBOR

Asset managers can temporarily use the Investment Book of Record (IBOR), which contains all valued portfolio positions and prices, as a backup accounting data source. An experienced accounting oversight group could leverage the positional information, historically expected daily deltas for fund receivable and payables, and capital stock information from the transfer agent to calculate the NAV. This process could require backup resource mobilization, large amounts of offline processing and potential patchwork operations. Nevertheless, using IBOR could be an option since it is already maintained for investment management purposes. In some cases, asset managers use the IBOR as an oversight tool on a day-to-day basis. In that case, more information could already be in the IBOR, enabling organizations to use it more quickly and robustly to calculate the NAV.

CONTINGENCY-DEDICATED PLATFORM

Lastly, a contingency-dedicated platform is another option rising in popularity. Asset managers are starting to turn to an internal platform, outside of the IBOR, that is designed and maintained with the sole intention of acting as an accounting contingency. This platform, enabled by either market vendor software or a homegrown solution, can utilize data from different internal platforms to maintain foundational data needed to calculate the NAV. If an outsource provider is unavailable, the platform would be able to complete the process (at least temporarily). This option is not as robust as a full shadow but is a more tailored contingency plan for fund accounting than simply using IBOR data. It has the potential to provide a high-quality contingency at a palatable cost. For both to be true, the asset manager must have a sound process and high-quality data surrounding the technology.

BE PROACTIVE WITH OVERSIGHT

By design, when outsourcing, asset managers inherit their service provider's plan to avoid or mitigate certain disasters. This key issue makes the due diligence portion of the selection process that much more important. One of the best ways to help protect the firm is to ensure its service provider has a sound contingency plan in place as well a strong track record of reliable execution. There are ways for firms to build in contingencies internally, but some may be costly or have short-term stopgaps. As a starting point, we recommend a robust, well-designed oversight model when outsourcing, regardless of contingencies.

The service provider's disaster recovery model becomes an extension of the asset manager. The provider could take on some financial liability in the event of a disaster scenario. However, the service provider cannot relieve the asset manager of its reputational risk. You can outsource functions and processes, but not responsibility. It is always the asset manager that must face its customers when a highly publicized issue occurs. This adds a complex layer of risk. Ultimately, a sound assessment of overall cost and benefit will drive which option to choose. Disaster scenarios could catch up with asset managers who fail to act.

CONTACTS

Girard Healy
Managing Director
girard.healy@accenture.com

Ross Tremblay
Senior Manager
ross.tremblay@accenture.com

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