Deloitte.

You and I were meant to fly
The rise of managed services

As financial institutions navigate today's unpredictable economic and regulatory landscape, the pressure on risk and compliance operating models has never been greater. Adoption of managed services is rising as firms seek a more strategic response in order to better organize, operate, and safeguard their business. Given that the adoption of managed services entails the transfer of a higher degree of control to a third party, determining when and how to adopt them is key. Get it right, and the potential rewards are significant.

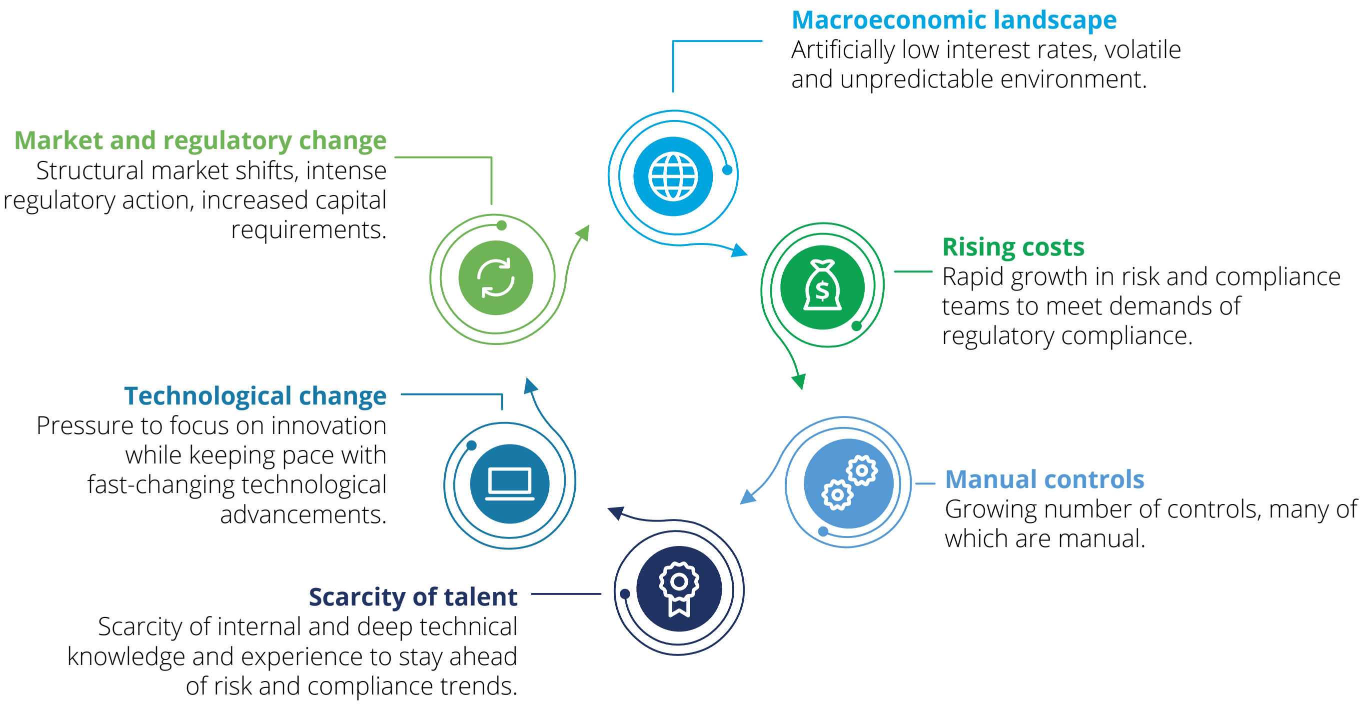
Since the financial crash of 2007-2008, business models have faced extreme pressure from market, regulatory, and macroeconomic forces. As firms have felt the burn on revenue, cost, and capital, the focus on operational efficiency and effectiveness has sharpened.

Risk and compliance functions are by no means immune given soaring costs to meet the demands of regulatory compliance. According to Citigroup, the cost is US$270 billion annually—10 percent of the operating cost—across the banking industry.[1] Much of this is due to a doubling of the size of compliance and regulatory teams in many of the biggest global banks,[2] a trend replicated across financial services.

These resources are often tied up managing manual internal control processes, thus limiting their availability to address pressing risk and compliance trends. Many processes are supported by legacy systems beset by under-investment as firms move to a "one-system" strategy.

Although new technologies such as automation and artificial intelligence could transform services, building in-house capabilities can be slow and commercially unviable. Finding people with the necessary skills and experience is just as hard.

External and internal forces driving firms to consider new operating models



Refocusing attention where it counts

Banks and other financial institutions are increasingly turning to managed services to address these challenges and to enable them to refocus their time and skills on activities of the most value to their business.[3] Market analysis indicates the global managed services market is expected to grow to US$229 billion by 2020.[4] Risk and Compliance are on a similar trajectory, as we see more Chief Risk and Compliance Officers turn to managed services to proactively limit enterprise risk and strengthen compliance.

What is a managed service?

In a managed services model, a strategic partner takes on, transforms, and runs business operations and processes to improve operational quality and efficiency on a long-term basis. It works particularly well for processes, people, and locations that are increasingly expensive to maintain and are not competitive differentiators. Within Risk and Compliance, the areas gaining most value from the managed service model range from third-party risk management and software asset management, to a range of cyber services, model risk management, and regulatory reporting.

More than a cost reduction exercise

The long-term, tightly integrated nature of a managed services partnership offers substantial strategic benefit in addition to cost reduction. In our experience, risk and compliance leaders are looking to transform business critical risk processes, taking advantage of scalable, innovative technology and expertise too expensive and time-consuming to build in-house, while also benefiting from predictable, outcome-based pricing, and reduced exposure to financial risk.

Benefits of managed services

Accessing a scalable, global third-party delivery infrastructure on a pay-per-use basis enables the bank to increase domicile and investment country coverage and increase volume without additional investment.

Growing adoption across Risk and Compliance

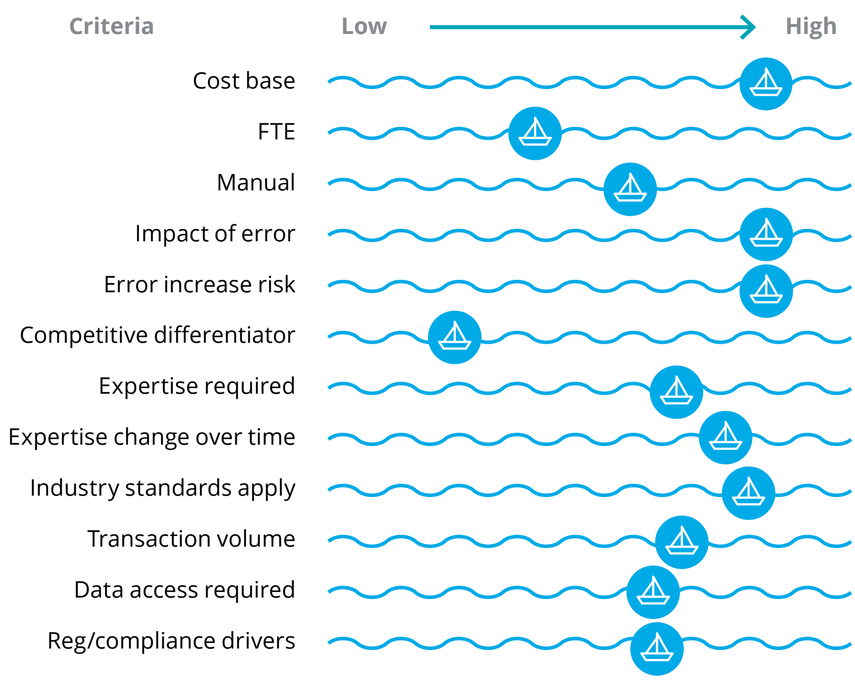
We are seeing institutions across financial services explore how they can realize these benefits within the Risk and Compliance functions. In one recent case study, a global bank deployed a managed services solution to reduce the cost of client tax reclaims and tax reporting while also improving service coverage and scalability. Given the nature of the service, it was critical for the bank to remain the "face" of the service to their clients, maintaining client data confidentiality, and a high level of service quality. The managed service achieves all these aims. Both running costs and annual maintenance costs are significantly reduced, by more than 30 percent and 100 percent respectively. Accessing a scalable, global third-party delivery infrastructure on a pay-per-use basis enables the bank to increase domicile and investment country coverage and increase volume without additional investment. As the white-labelled service meets rigorous compliance and quality assurance standards, it also ensures the bank continues to deliver a seamless, high-quality service to its clients.

Another recent example saw a US bank needing a more effective way to address new lease accounting and reporting standards, ASC842 and IFRS16, which require all lease transactions and financial disclosures to be captured on the balance sheet by January 2019. Like many other companies, the bank relied on mostly manual processes to manage this data, and initially focused on software solutions such as SAP ERP to achieve compliance. However, after realizing technology alone could not support the adherence and compliance requirements, the bank turned to a managed services solution designed to both meet the regulatory priority and deliver wider long-term benefits. With the solution in place, the bank benefits from a re-engineered lease accounting and reporting model driving faster, more accurate processes, and improved confidence in compliance through access to trained staff, ongoing support, and high-quality, audit-ready monthly reporting packages. The total cost of ownership is also lower, and outcome-based pricing gives the bank the flexibility to scale up or down to meet current and future reporting commitments, as well as compliance mandates.

Determining the best fit sourcing model
With the variety of sourcing models on the table, how firms determine which fits a particular operation or process is critical. We believe the interplay of 12 criteria determines the suitability of a particular process for insourcing, outsourcing, or a managed service.

Typically, a managed service is most applicable when failure poses a high enterprise risk, when the need for expertise is urgent, specialized, and evolving quickly, and when competitive differentiation is low. In these scenarios, the costs and challenges of building a cutting-edge function in-house may not pay off through market differentiation, while the transactional, shorter-term nature of traditional outsourcing models represents too high a risk.

Profiling a process or operation suitable for managed services



Let's consider the example of model risk management.

The number of models relied on by banks and other large institutions is rising fast—by 10-25 percent annually according to McKinsey.[5] These models support ever-expanding areas of decision-making with increasing sophistication, enabled by technology developments, such as automation and Big Data analytics. Global regulation is also increasing, as the US SR11/7 standard becomes the "de-facto" benchmark for model risk management functions on both sides of the Atlantic. These factors mean managing the risk of defective or misused models is increasingly important, complex, and expensive. In addition, workload peaks and troughs are putting more pressure on specialized skills that can be hard to source and maintain in line with the latest intelligence. While risk models can certainly provide competitive differentiation for a firm, a standardized model validation process does not. Therefore, model risk management fits the profile for managed services—increasing cost, high enterprise risk, low competitive differentiation, and scarce talent.

By leveraging a strategic partner's specialist, multi-faceted technology, processes, and expertise to run all or part of the function, a firm can deliver the complexity and volume of firm-wide modelling more efficiently. This frees up the in-house workforce to focus on the higher value tasks of decision-making and independent challenge through monitoring, reporting, validation, and governance. In addition, the partner's knowledge of industry-leading practices and regulatory expectations improves confidence in production models by normalizing them against best practice and global regulations. Operational costs also benefit from the scale efficiencies of a global "around-the-clock" utility service, and from more predictable pricing based on outcomes.

Implementing managed services successfully

Clearly, the transfer of more business critical operations to a third party requires careful management under the watchful eye of regulators. Four aspects are particularly key to successful implementation:

Choice of managed service provider
Although cost inevitably plays a role when choosing a teammate, to realize the long-term innovation, talent, and quality benefits of managed services requires a stronger focus on strategic fit, and on a provider's level of investment, global consistency, and domain and regulatory maturity.

Transition approach
Given that managed services may move control of a process externally for the first time, the right approach to transition—whether it be parallel runs, staggered transitions, or piloting—is critical to ensuring adequate safeguards and oversight are maintained through the process.

Vendor management
Introducing a long-term partnership model will require enhanced governance procedures for many vendor management functions. New procedures will ensure partners have the capability to meet required outcomes, both at the point of selection and throughout the subsequent delivery of services. Clear dispute resolution mechanisms and decision-making accountability will further aid robust vendor risk management.

Stakeholder management
As one would expect when adopting a new operating model that transfers a greater degree of control to a third party, how the concerns of stakeholders such as regulators, investors, and employees are managed will be critical to a smooth and timely implementation, and to realization of the desired benefits.

A path forward through an uncertain future

Looking ahead, the forces driving institutions to adopt the next evolution of outsourcing are unlikely to weaken their pull. Risk and compliance leaders will continue to feel pressure to cut costs and improve the effectiveness of processes from cybersecurity to reporting, remediation, and legal advice, all while responding to regulatory expectations and delivering against core business priorities. For the firms responding by adopting a managed services model, the potential rewards are significant. In addition to cost efficiency, scalable access to the latest technologies, expertise, and knowledge is already improving outcomes across a wide spectrum of critical risk, regulatory, cyber, legal, and compliance operations.
As confidence in the model grows, we believe adoption will widen further, enabling firms across financial services to focus their precious resources and skills where it matters most—on driving growth and competitive advantage.

Article was printed with the permission of Deloitte UK. It originality appeared in "Inside magazine - Edition 2018"
https://www2.deloitte.com/lu/en/pages/about-deloitte/articles/inside/inside-risk-2018.html

Contacts

Hugo Morris
Risk Advisory
Deloitte UK
hmorris@deloitte.co.uk

Mark Whitehead
Risk Advisory
Deloitte UK
marwhitehead@deloitte.co.uk

Jamie Laing
Risk Advisory
Deloitte UK
jblaing@deloitte.co.uk

Endnotes

1. Martin Arnold, "Banks' AI plans threaten thousands of jobs," Financial Times, 25 January 2017
2. Ibid
3. Deloitte University Press, "Managed Services: a catalyst for transformation in banking"
4. Statista.com, "Managed Services market size worldwide 2014-2020"
5. McKinsey & Company, "The Evolution of Model Risk Management," February 2017

This article was printed with the permission of Deloitte UK. It originality appeared in "Inside magazine - Edition 2018" which is published by Deloitte Luxembourg and can be found on the Deloitte webpage.