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To outsource or not to outsource

André Rousseau
Director
Advisory
Deloitte

Janina Kotze
Senior Consultant
Financial Services
Deloitte

Ross Fitzcharles
Senior Consultant
Financial Services
Deloitte

The key question for many players in the investment management industry is whether they should focus on their core business only and possibly outsource their administration.

Outsourcing is the process of delegating a company's business process to third parties or external agencies, leveraging benefits ranging from possible low-cost labour and improved quality to product and service innovation. There have been many different reasons driving this hotly debated topic on the market. Both the insourcing and outsourcing decision has a direct impact on the efficiency of the business and hence the bottom line and related control discussions. Deloitte has interviewed an outsourcing administrator in South Africa to understand their thoughts on the outsourcing model. In addition, we have had a discussion with an asset manager to get a better understanding of the overall picture.

Questions to administrator

1. What would you rank as the top reasons for companies to outsource their back-office operations?

I would say it is driven by cost reduction, although this should only be ranked in third place among the top reasons. The other top two reasons would be for asset managers to leverage large-scale benefits, such as making use of a larger pool of skilled resources, and lastly for the asset managers to be able to focus on their core functions.

If I had to rank the factors influencing the outsourcing thought process from the perspective of an asset manager, I would say firstly, an increased focus on core internal functions, secondly, being able to leverage large-scale benefits and lastly, reduction of operational costs such as technology overheads. Asset managers should be focusing on brand, product and distribution. Outsourcing providers focus on downstream operations, technology, infrastructure and people.

Some clients expect to outsource the relationship with the investor

2. What is your view of risk outsourcing being one of the main reasons for companies to outsource?

It is true that when outsourcing, the risk and accountability of inaccurate processing is transferred to the administrator. However, an administrator has to price this risk into the rate card, so although outsourced, the asset manager still carries some costs relating to risk.

To fully answer the question, it is important to understand the way in which the industry is split. There are institutional administrators and the larger retail/fund accounting companies. The liability for retail or fund accounting companies is large, meaning that if you get a price wrong on a fund, it translates into a potentially large liability for the business. You need to have a decent balance sheet to back up that level of risk. Liability for institutional administrators is far smaller. It is limited to trade errors and the biggest risk lies with the platform business. Liability related to the process of balancing model portfolios is larger than that of pure administration, but this also does not run into the hundreds of millions since it is at a per-investor level. Also, on cash transactions, an incorrect distribution and pay-out could occur, but this is recoverable and there is therefore limited liability.

If outsourcing is driven by a desire to outsource risk, it is best to look for outsourcing providers who have a decent balance sheet and comprehensive insurance cover.

3.Most provider selection processes go through formal RFIs and RFPs (Requests For Information/ Proposal), and clients start off with a long list of potential providers and conduct proper due diligence before they make decisions.

a) What are the main 'value-add' activities that you offer to clients?
b) What differentiates you from the rest of the outsourcing providers?
The 'value-add' or differentiating factor is first and foremost our reputation within the market. Above all, we strive to deliver on our promises. Other aspects include the fact that we own our own technology in-house, meaning our clients are not exposed to dollar-based pricing on technology; the scale of our business and our company's track record; and the quality we deliver, i.e. our low error rates. We are also sufficiently confident about our quality that we do not benchmark on price, but on quality. Our error rate is less than 0.5% for unit trust clients and less than 1.5% for platform clients.

c) What are the critical areas of success for outsourcing investment back office operations?
The asset manager's business model is one of the most important aspects. The complexity of the investment products and broker relationships should be understood and carefully considered. Client relationships are also key, identifying the critical touch points for communication to drive proper change and a full transition. Another is pure data; the data conversion should be accurate and precise to ensure a start on the right foot.

Lastly, I would mention integration—this is very important as part of a 'black box solution' offered to clients. Nowadays, clients expect this box to include fully transactional web services, integration to banking systems and other group components as well as communication with the client's large-scale broker bases to bring in flat files, etc.

4. One of the main considerations that prospective clients look at is the amount of capital outsourcing providers spend on investing in system improvements and process innovation.
a) What percentage of the annual budget is spent on system improvements and process innovation?
In order to answer the question, it is important to understand that the percentage of revenue budgeted for system improvements and process innovation needs to consider the influence of regulatory changes, which translates into costly process and technology changes. Another key factor is the volumes required to drive sufficient turnover for investing; we invest between 5%-10% of turnover on system improvements and process innovation per annum.

b) In terms of investing in system and process innovation, how do you measure return or cost savings?
Measuring cost saving is first of all being able to achieve more with the same or smaller amount of people. This should result in a lower cost and increased revenue output. To this end, however, administrators must embrace Straight Through Processing (STP) and invest in seamless integration and automation to remove repetitive, redundant and manual intervention. Any innovation should further reduce the total cost of ownership of a system which includes possible direct and indirect costs.

5. In an era of record regulatory fines, there is focus on asset managers to have effective oversight and supervision of the outsourcing service provider's operations.

a) Do you find the oversight of asset managers on your business processes to be a burden?

We view transparency and trust as a standard part of our service delivery. It is therefore not viewed as a burden, rather an area of competitive advantage.

b) What is required from you to provide them with an effective oversight and supervision model?

We provide clients with peace of mind through objective reviews and proper internal controls. This is enforced through high quality internal audits, transparency of external audits and adherence to standards for internal control. Our internal audits are comprehensive and objective, which is evident in the fact that they are not performed by our own internal audit team but by an audit team provided by our clients.

c) How do you manage this relationship?

We manage this by providing total transparency and ensuring a 'total trust' relationship with our clients. We take every effort to ensure quality audits which should bolster trust relationships. We require auditors to have good industry insight and knowledge of our company and aim to have continuity in this regard.

6. In general, what liability does the outsourcing service provider carry, in terms of:

a) 1) transactional errors, and 2) reputational damage?

An outsourcing provider should always limit its liability in contractual clauses. We contract out our third-party liability therefore only direct asset management clients have recourse to us. Recourse amounts are capped and linked to between 50% and 100% of the annual fee.

7. Finding the right staff seems difficult, especially with outsourcing providers claiming that they specialise in fund administration.

a) How difficult is it to find and retain experienced staff for your business?

The current availability in the market is good, but it is also clear that resources are much more qualified today than in the past. In the early days, the average administrator just had a high school certificate whereas today, the average administrator is better qualified. Subsequently, the expectation from staff has also increased. It has become more difficult to retain the newer, younger generation resources as they join the administrator to make a high impact in a short time in order to gain sufficient experience to possibly move on. We attract good resources quite easily as we are a well-reputed employer. This is largely due to the steep learning curve experienced by staff. The major trade-off is that larger banks are aware of this and inevitably offer our staff positions once they have experience.

8. What are the assets under management of the clients that you would consider outsourcing?

The amount of assets under management of clients looking to outsource varies. There is, however, a minimum bracket applicable to clients with whom administrators will engage in business. Generally speaking, our operational efforts are split approximately 50/50 between clients with AUM of less than R50 billion, and clients with AUM of more than R50 billion.

9. Looking at your clients across the spectrum, how many transactions are required to reach profitability?

The exact number of transactions differs from client to client, however a general rule of thumb is that if profits do not show within the first 18 months of a relationship, cost, risk and liability should be reassessed.

10. How does your pricing model compare with or differ from an AUM fee pricing model?

We don't charge an AUM fee as a primary source of income. AUM fees are only charged if the complexity of the operations warrants it, which is normally related to platform products. In the unit trust business, which is becoming increasingly standardised, fees are transaction based. The reason for this is that our risk is transaction based, i.e. based on the number of people and amount of technology required to perform a trade transaction. We also found that a growing number of asset managers are reluctant to pay an AUM fee as they are keen to marginalise the cost per transaction.

11. What are some of the myths you find clients believe or challenges due to incorrect perceptions?

Up-front clients believe "outsourcing will be much cheaper". Although some direct administrative costs are cut, it is not necessarily cheaper. That said, asset managers definitely gain a great amount of value through outsourcing. Clients believe outsourcing instantly simplifies their current complex processes. They forget the trials and tribulations encountered with administration in-house; and try to outsource their problems. The greater number of human interventions can result in error and/ or create complexity at some point.

They also believe that outsourced operations will make their technology investment costs disappear. This is not true; although the client does not physically own and maintain the technology, there will always be investment in technology. This enables clients to pay a fraction of what other companies pay for technology.

Further to the myths mentioned, there are also some challenges between the outsourced provider and the client. Clients' expectations that processes should be faster, irrespective of the added complexity and constraints, become unreasonable. Clients outsource a product's administration, for which they remain the custodian, but they themselves do not fully understand the complexity surrounding the administration of such a product.

Some clients expect to outsource the relationship with the investor. For example, platform products have complex distribution channels, which require a customised approach and specific attention. This remains the responsibility of the asset manager, thus nurturing the relationship with the investor.

12. What are some of the main issues/softer touch points that need to be addressed when clients are transitioning to outsourcing?

Simply put, clients struggle to let go of the past. The way in which administration is carried out in-house versus outsourced will change during outsourcing and therefore, a relationship of trust must be built.
A major touch point is around ownership by the right people and at the appropriate levels to be able to make key decisions. Transition to outsourcing require visionaries and change agents. Otherwise, processes and systems are just customised to produce the same old results, which led to the decision to outsource in the first place. More often than not, change is owned at too low a level, or by individuals who are not geared towards the strategic growth of the company.
Lastly, I would stress the importance of understanding the reasons behind the outsourcing decision to make sure the outsourcing agreement meets the client's expectations.

We have succeeded in creating relationships across the range of management levels and role players. We provide control and transparency as a default. Client confidentiality and data security is an area where we have made major investments, and this is taken very seriously. We consider ourselves to be ahead of the curve in this area, employing various data intervention and scrambling techniques, penetrations tests, cyber security, IT audits and data oversights, etc.

13. What do you think is the biggest threat to Investment Administration Outsourcing?

I think one of the biggest threats to outsourced administrators is technology automation where the way of the future is simply an online switch. Data processing hubs can only survive if automation is low and market uptake for technology is slow. Currently, asset managers and brokers are just not sufficiently feeling a price squeeze to fully utilise electronic channels and remove manual processes such as the manual forms and OCR (Object Character Recognition). Subsequently, other specialised technologies simply do not work as well as intended in a complex, rule based environment. The other threat, closely linked to technology, is Straight Through Processing (STP). STP dramatically reduces cost per transaction, but is dependent on electronic data feed channels.

Besides threats to outsourcing administration, the investment management industry as a whole is also looking at a major threat: getting hold of new money. Presently, the churn rate is only increasing with increasing competition, competitors are stealing each other's' investors. Investors are paying an increasing amount of switching fees for limited performance in a flat market. Where will the 'new money' come from, if the 'currently unbanked' are not investing?

As an end note regarding market appetite, the appetite for outsourcing unit trust (mutual fund) administration is far greater than that of platform products. Unit trust administration is seen to be an arm's length activity and distribution is not complex. It is rather fund and fund performance management that sells the product. The LISP (Linked Investment Service Provider) industry is immature and many of the old complex investment products are still in the market, making administrative standardisation very difficult. This in turn reduces the inclination to outsource the function. As the new LISPs of the world come into play, the appetite for outsourcing LISP administration should also grow.

Questions to Asset Manager

1. Outsourcing is a viable option for many asset managers looking to grow their operations and networks, but there are many aspects to consider in determining whether this is the right choice.

a) What are some of the main barriers that asset managers should consider when deciding whether to outsource?

First of all, the smaller asset managers don't actually have a choice as they do not have the capital to invest in infrastructure to operate their own fund administration. Also, recruiting the right staff is a challenge and if an asset manager is located in a remote area, they will find it difficult to attract the right staff with the required expertise. Larger asset managers can actually perform fund administration at the same cost as outsourcing, but their decision would be driven by their focus on core business rather than cost.

b) What made you consider outsourcing?

Due to standard processes around settlements and transactions, etc., outsourcing is becoming a hot topic and the outsourcing provider actually focuses specifically on these commodity-type services. There is an expectation that outsourcing providers have the expertise to perform these services effectively, and this allows us to focus on our core business functions. Also, having to spend capital on resources, training and system upgrades, etc. is making us reconsider the effort and capex versus the actual benefit that we get from keeping these functions in-house. These are unnecessary issues that just distract our focus.

c) What are the key principles that you look for when selecting an outsourcing provider?

One of the key principles is definitely the need to buy into the outsourcing provider's operating model, as our core business should not be impacted when outsourced. What is also important is their adaptability to regulatory changes and how effective they are at dealing with sudden changes imposed by regulators.

Process transparency plays a huge role as this determines the effectiveness of our relationship with them, and the ability to negotiate bespoke processes. Lastly, we also look at the experience of their staff and their ability to retain staff - as we know from experience that this is a challenge.

2. A well-developed support service for asset managers can leverage capabilities, reduce cost and increase agility to deliver sustainable business value.

a) On a scale of 1 to 10, how effective and efficient is your in-house support service (back office processing)?

I would give our in-house support service a 5 out of 10 and this is largely due to the special admin complexities that increase the risk of handling the administration of funds. There are various bespoke processes and workarounds that need to be created to manage issues, and this also adds to the risk and complexities.

b) Does your back office support service deliver true sustainable business value or is this more of a burden (cost centre) to you?

Most of the fund administration is standardised and assists the core business, but it is the bespoke processes that you create around older and weaker systems that end up being a burden to the business. As mentioned earlier, keeping up-to-date with all versions and upgrades requires great amounts of capex and this can distract from the business' core focus and eventually result in decisions being made not to upgrade. This in itself creates downstream issues and complexities and ultimately turns your support service into a burden or cost centre.

3. In an era of record regulatory fines, there is a regulatory focus on asset managers to have effective oversight and supervision of outsourcing service providers' operations.

a) What effective risk measurements and in-house processes do you have in place to monitor the outsourcing service provider's operations?

Well, the FSB (the Financial Services Board) requires that you have sufficient processes in place to monitor the outsourcing provider since the overall liability still sits with us as the asset manager. This again requires additional capex to recruit the right staff with adequate experience to monitor the outsourcing provider. The main challenge lies in recruiting and retaining the right staff as the competition in Johannesburg is high. If you don't have staff with the right experience or sufficient staff capacity to monitor and oversee these processes, you will lack a stringent oversight and supervision process.

To the **point:**

Strategic reasoning behind outsourcing:

- A drive to focus on core activities and enabling the redirecting of key resources to core activities
- Trying to unlock operational efficiencies by collaborating with an existing outsourced solution platform
- Accelerating the enablement and possible migration to new technologies
- Possible savings from reduced overheads and certain direct costs
- Staffing flexibility and possible mitigation of talent shortages required from the asset manager
- Possible outsourcing of risk management from a process point of view. The reputational and client risk, however, remains the responsibility of the client facing asset manager/wealth platform

Established myths:

- Outsourcing will solve all the internal problems of the asset management company
- Outsourcing will always make you save money
- Outsourcing companies will always perform the function better than what the asset manager could

The decision of outsourcing should be based on the right reasons and inevitably managed through a stringent vendor selection process. The relationship should be fully collaborative and transparent to ensure a trusting business relationship. There are many advantages of outsourcing, but these can easily be negated by not having measurable controls in place with fully agreed accountability metrics.