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## Solid Relationships: Investment Managers and Service Providers Using Collaboration to Build Reliable Middle-Office Outsourcing Models

In the last several years, middle-office outsourcing has become an important consideration for investment managers as they evaluate their current business models and renew their focus on core competencies. When used effectively, middle-office outsourcing can generate additional efficiencies and savings, provide more predictable cost structures and help increase speed to market for new products. However, there must be a thorough evaluation of the business first before the right solution can be found. In order to decide whether positive results are likely to be achieved from outsourcing services, it is important to look across the entire organization of a firm and determine which existing systems and processes may be replaced by a solid outsourcing model from a service provider. Choosing the right suite of middle-office outsourcing services can help asset managers focus on critical front-office services without the potential distractions that may come from running their own middle-office functions, which can be costly in terms of time, money and resources.

With a broad array of outsourcing services and various ways of creating a servicing relationship, this may seem like a daunting process, but there are a lot of advantages to “getting it right.” When service providers and investment managers collaborate to find the best solutions, it can be a winning outcome for both parties. Investment managers are able to excel at what they do best—managing assets and winning additional clients—while service providers are able to deliver their back-office services together with middle-office outsourcing to create a seamless offering for their clients.





# What is Middle Office Outsourcing?

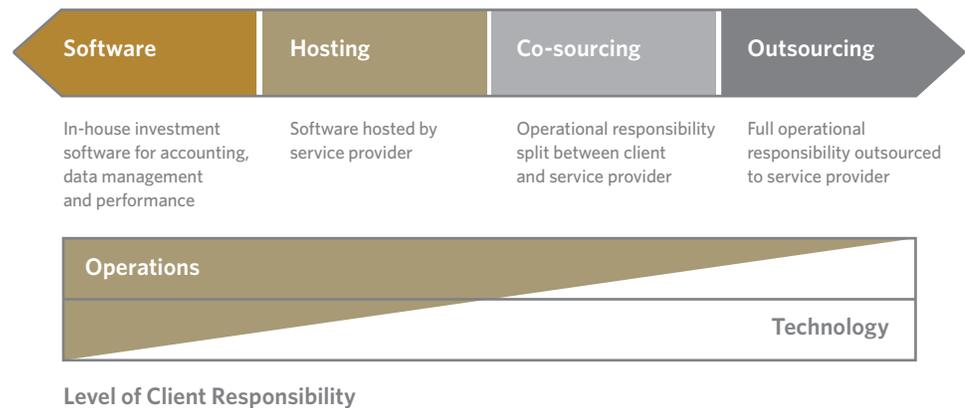
While back-office services have been outsourced to third parties for many years, with adoption rates of over 90% for US asset managers and an even greater percentage for European investment managers, middle-office outsourcing is relatively new, with adoption rates from 15% to 20% of the market.<sup>1</sup> Experienced service providers recognize that investment managers want to maintain control over their front office while having a seamless integration of middle- and back-office services. Exhibit 1 below illustrates the services that make up the front, middle and back office.

**Exhibit 1: Services in the Front, Middle and Back Office**

Front Office			Middle Office							Back Office		
Marketing/ Client Service	Portfolio Management	Trading	Data Management	Trade Processing	Position Keeping & Accounting	Performance & Attribution	Client Billing	Client Reporting	Reconciliation	Custody & Trustee	Fund Administration	Transfer Agency

Asset managers can look across a spectrum of options as they consider what will work best for their business model. As one moves across the spectrum, there is a trade-off between how many functions the service provider will perform for the client and how much control the client is willing to give up regarding their middle-office processes. In other words, if less control is given up, fewer services can be provided. Exhibit 2 below offers a depiction of this range of options, which is also known as the Service Delivery Continuum. The shaded area illustrates the client’s changing responsibility for Operations and Technology as they move from one level of service delivery to another.

**Exhibit 2: The Outsourcing Service Delivery Continuum**



<sup>1</sup> "Trust Banks: An Investor's Guide to Middle Office Outsourcing." Bernstein Research, May 19, 2011.

At one end of the Continuum lies the Software option, where software is licensed from a technology vendor to improve in-house processes. Leading-edge technology and software is at the heart of any outsourcing solution, and asset managers benefit from receiving more robust data for decision support applications. This choice is best for asset managers who are satisfied with their in-house model but need a fresh platform to stay up to date.

The Hosting option offers additional benefits relative to the Software option. Rather than being hosted on the asset manager's data center, the platform is managed on the service provider's data center. By selecting this route, asset managers are assured that they are not using end-of-life hardware, and they do not have to worry about technology upkeep and the latest software releases, updates and changes. However, clients would be responsible for testing the software to make sure it is working as expected. Hosting is best for asset managers who have difficulties maintaining their technology platform.

With Co-Sourcing, software is hosted in the service provider's data center just as it is in Hosting, but in this instance, the service provider rather than the asset manager is responsible for running the software as well as maintaining it. Co-Sourcing is just one piece to consider when asset managers look at buying one or more middle-office services instead of a full outsourcing solution, and is also referred to as a component model. This model, which allows asset managers to "plug and play" for selected services, is ideal for those who are looking to make small changes to their business model to improve efficiencies and cost structure.

Outsourcing comprises the full suite of middle-office services. Many asset managers commit to a full Outsourcing solution when they want the full benefits of focusing on their core business while taking advantage of superior technology and processes from an experienced provider. This option has been gaining momentum as asset managers see the range of value-added services that are offered.

## Outsourcing Before and After the Recent Financial Crisis

Outsourcing was not always such a popular topic; in fact, it was considered a slow-growth product for many of the 20 years that it had been in existence. In 2005, outsourcing had been adopted by 12% of traditional asset managers and 7% for hedge funds.<sup>2</sup> At the time, outsourcing was not thought to be a necessity because markets were functioning smoothly and investment managers were generating sizable profits. In this environment, managers could easily afford to upgrade their proprietary technology and services in order to create consistent trade processes. However, much has changed since the recent financial crisis, and as a result many firms are looking for better ways to weather unpredictable markets with the help of service providers.

The global financial crisis that occurred just a few years ago was a staggering blow to the financial industry in a number of ways. As stock prices fell and liquidity became scarce, investment managers realized they had more important things to worry about than whether or not trades were being processed efficiently. Not only were revenues falling, but costs began to rise as new regulations were put in place that required heightened risk management and increased transparency. Suddenly, the investment management industry was hit with a number of concerns, chiefly:

- How can I stay focused on my core functions as a money manager while receiving support for certain back-, middle- and front-office services?
- How do I manage times of growth or times of contraction?
- How can I maintain a reliable technology infrastructure that keeps pace with the changing regulatory environment and avoid technology maintenance and upgrade costs?
- How can I develop and distribute new products and services that meet the growing sophistication of investors?

Today, uncertainty still remains as investment managers keep up with geopolitical struggles, natural disasters and new regulations alongside the day-to-day movements of the financial markets. Not only must they navigate the choppy waters of change around the globe, but they also must find cost-effective and efficient ways of handling trades. In addition, investment management firms must also evaluate the effectiveness of their front-office systems, which their financial professionals depend upon for receiving the most up-to-date information in order to make the best possible decisions. Needless to say, the challenges are significant, but the good news is that outsourcing may be a solution.

<sup>2</sup> TowerGroup Report, 2005.

## Challenges Faced by COOs

In the new financial landscape, asset managers are feeling constraints on all sides. How does a firm produce attractive profit margins and generate growth while adhering to the transparency and disclosure requirements that make up many of the new regulatory changes? How are costs to be contained while striving for operational excellence? It is a tall order to be sure, and many of these burdens have been transferred from the Chief Investment Officer and Chief Executive Officer to the Chief Operating Officer, or COO. This senior manager's plate is already full, since he or she is responsible for supporting post-trade processing, investment accounting, custody reconciliation, cash management, corporate actions processing (focusing on voluntary actions), performance management, derivatives processing (including collateral management), risk reporting, investment management reporting, as well as client statements and billing. Often, COOs will review their options and find a middle-office outsourcing solution along the Service Delivery Continuum when it is determined that some or all of the previously mentioned services can be performed more efficiently with the help of a service provider. However, it may be difficult for a COO to give up control, since he or she is ultimately accountable for the success of technology and operational solutions. In short, COOs want to work with a service provider that fosters trust and collaboration while delivering a consistent, high-quality suite of services. To ensure that this kind of relationship exists, asset managers should receive regular updates from service providers that offer a transparent look into middle-office outsourcing processes, with information delivered in a way that is easy to use and understand.

Outsourcing service providers have always strived to give some degree of transparency through the use of soft-copy reports and through regular phone calls between the service provider and asset manager. These mechanisms could use some improvements, of course, because they focus on the service provider pushing information from a single point in time to the asset manager, who then has to filter and sort through countless reports to generate meaningful data. Often, this system has created more questions than answers as asset managers struggle to look for a specific transaction, compare service levels occurring at different points in the day, and ultimately determine the overall quality of the services being provided.

Service providers can respond in a number of ways, from making information delivery more robust or focusing on service level agreements to give a monthly update on the services provided. From an information-delivery standpoint, service providers might look at standard and ad hoc reporting, which allow asset managers to receive reports on holdings, trades, cash and other aspects of the portfolio on a daily basis, while at the same time answering other questions pertaining to specifics within the asset manager's outsourcing arrangements. From a service perspective, there are many ways to improve the current structure. In order for asset managers' expectations to be met by any new enhancements, it is helpful for service providers to hold collaborative sessions in which both parties can meet and decide the best approach to use going forward. One such example would be the process that BNY Mellon used to develop its new trade status dashboard, a web-based tool that allows clients to view various stages of the post-trade lifecycle. The following case study illustrates how BNY Mellon and its clients worked together to create a better way to view middle-office outsourcing data.

## Case Study: OnCore Trade Director Dashboard

Last year, BNY Mellon hosted a Client Advisory Board event, where clients were invited to participate in a forum focusing on their current drivers and concerns. During this event, asset managers expressed the need for on-line transparency into each of the outsourcing services they purchased. They wanted to understand the underlying systems that were used in these services to make sure that processes were running properly. By having a deeper understanding of how outsourcing services were being handled, they would be able to achieve great comfort with the entire process and ensure that their needs were being met.

In response, BNY Mellon decided to focus time and effort on creating a transparent view into its outsourcing services. The BNY Mellon team created a concept for a web-based operational dashboard, which would show daily transactions, various stages of the post-trade lifecycle and the overall state of the services being provided. None of the features identified or asked for were particularly technically complex. Rather, the challenge lay in addressing the need for simplicity. The user interface had to be intuitive so that minimal training would be required in order to use the tool and find information quickly.

The application was created by incorporating feedback from clients and prospects during development. Continuous communication between BNY Mellon and asset managers helped the development team stay on target and modify the initial blueprint using the input of actual users. In the end, BNY Mellon was developed an operational dashboard that displays pertinent pieces of a trading lifecycle and allows a client to examine its brokers' operational efficiency and identify themes about a service through a specialized query tool that incorporates a number of different parameters.

Feedback from asset managers has been overwhelmingly positive, and changing the process from a "push" to "pull" has significant advantages for BNY Mellon's clients. Asset managers are able to gain more comfort with their outsourcing solution by looking at the state of a service when it is important to them. They are able to perform research or analytics against that same data to quantitatively measure the success of the service or providers (like brokers), as well as identify themes that affect the efficiency of a service.

## Conclusions

By giving asset managers more control over their data, questions are oriented more toward self-service capabilities, and only critical items require a touch point with the outsourcer. Ultimately, the asset manager can use the information from the dashboard to build a more trusted relationship with the service provider. They will be empowered to assess the quality of their outsourcing services by using these new interactive tools. Their awareness is heightened through alerts, visits to the dashboard or by running a report, which gives an overall level of comfort with middle-office outsourcing. By developing these solutions with a service provider using a collaborative approach, the asset manager is now in the driver's seat, with control, transparency and a service-provider team that can be thought of as an extension of their own.

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## About BNY Mellon

BNY Mellon is a global financial services company focused on helping clients manage and service their financial assets, operating in 36 countries and serving more than 100 markets. BNY Mellon is a leading provider of financial services for institutions, corporations and high-net-worth individuals, offering superior investment management and investment services through a worldwide client-focused team. It has \$25.9 trillion in assets under custody and administration and \$1.2 trillion in assets under management, services \$11.9 trillion in outstanding debt and processes global payments averaging \$1.6 trillion per day. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation (NYSE: BK). Additional information is available at [www.bnymellon.com](http://www.bnymellon.com) or follow us on [Twitter@bnymellon](https://twitter.com/bnymellon)

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