Outsourcing in a brave new world

Outsourcing has reached a new norm, following the financial crisis and the regulatory change that resulted from it. Buyers no longer want relationships where they are bound to large-scale lift outs. Instead they want component-based services.

Following an image makeover lasting six years, outsourcing is now sporting a new look. In the pre-Lehman era, the market saw a flow of middle- and back-office lift outs. However, regulatory and market changes since the financial crisis have resulted in more bespoke outsourcing of components. In some cases regulators have found previous outsourced relationships to not be fit for purpose, and they have forced increased oversight and unbundling on the market. Amidst increasing complexity following these events, global custodians are struggling to meet every client's needs. In addition, the need for transparency and cost efficiency is being stretched.

Annalisa Bicknell, regional head of sales and relationship management for institutional investors for BNP Paribas Securities Services in Europe, notes the change in dynamics in middle-office outsourcing "The second generation outsourcers have more experience in seeking best of breed, component outsourcing towards specialist providers."

Re-insourcing carries with it operational data and reporting requirements of the sell side. "We have seen this among a couple of our contacts but it's a question of what are pension funds going to establish in-house and what are they going to use a provider for," says Bicknell.

"More complex regulation means clients are demanding best of breed from providers for Solvency II reporting."

Solvency II regulation aims to review the prudential regime for insurance and reinsurance undertakings in the European Union.

The trend towards unbundling has also spurred an interest in dealing services with Bicknell noticing a trend where asset managers look for market intelligence elsewhere than their dealing desks.

Service level agreements and KPIs remain essential in an outsourcing agreement. "They define the relationship that is going to be delivered and provide transparency of the many components that make up an outsourced relationship such as the client service models, fees etc… Ultimately, to make an outsourced relationship successful it has to be a mutually beneficial partnership."

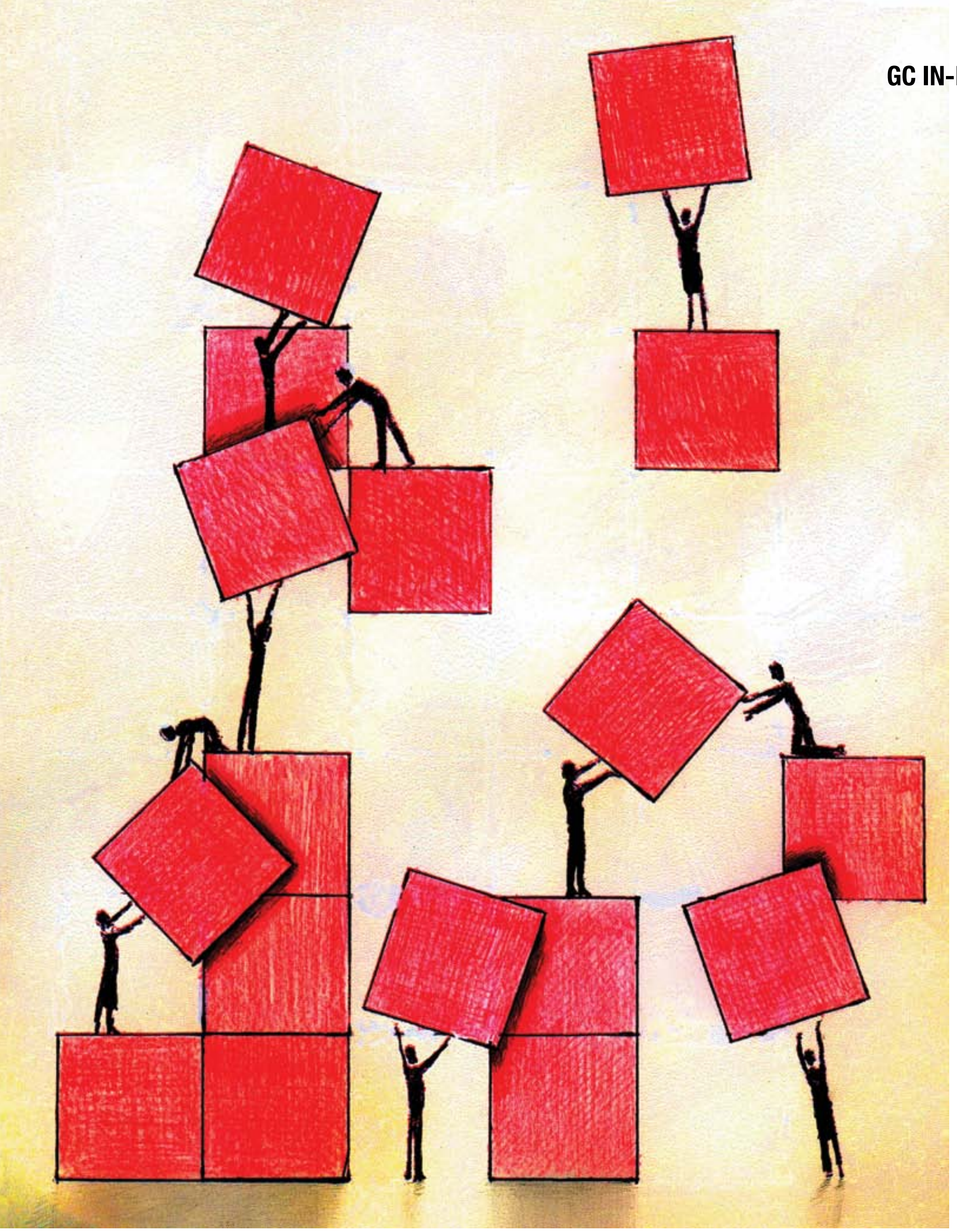
Julian Kasparian, who represents sell-side brokerage clients at BNP Paribas Securities Services, has seen a number of prospective clients on the back of regulation. This, he says, is a sign of the challenge in managing operations. "Historically they looked for a provider so that they could focus on their core competencies such as research and execution and not operations," he says. "Mid-tier players have various changes, and they are looking at cost efficiency. They're asking, 'What is the value we need to provide?', while custodians provide operational expertise such as clearing and asset services, tax [services] and corporate actions."

Kasparian also highlights increasing costs to the sell side in absorbing central securities depository regulation (CSDR), European Market Infrastructure Regulation (EMIR) and other market infrastructure changes such as TARGET2-Securities (T2S). "We are now in the mid-tier broker space where people are outsourcing their back-office to us," says Kasparian. "When you take them through T2S and all these challenges, they can focus on their core business."

Tier 1 buy-side firms, however, still have difficulty with outsourcing. "It's difficult for the bigger players because they have to outsource control," says Kasparian. "They may not decommission everything but it's more about expertise where we can take advantage of level of services and systems enhancements. It's no longer settlement and clearing but about creating an operating hub internally that clients can visit."

One size fits all?

Legacy systems of custodians have also contributed to outsourcing's makeover. Steve Young, CEO of consultancy Citisoft, notes a cynicism in the market about the standard operating model of custodians and the customers it can take on. "It is difficult for the larger outsource providers to



compromise on their standardised situation," he says.

A strong, single operating model with a global focus appears to have more success than a standardised offering, but customisation isn't easy.

"The more bespoke they are the harder it is in terms of economies of scale," says Young. "The challenges some of those existing vendors face is how do they upgrade that technology stack and who will pay for that?"

Young is also seeing a lot of component-based outsourcing particularly around regulation. "With AIFMD (Alternative Investment Fund Managers Directive), many asset managers are looking to outsource administration of regulatory reporting, as it's easier for an administrator to handle," says Young. "Outsourcers will take a take a lot of business, there will be more pricing, and a more holistic service. Over time the outsourcing provider will need to work on their costs and services.

"It will be about these component insights such as reference data and data management. Different players, with different degrees of success, have the opportunity to take different parts of the value chain."

New capital market for Europe

In the case of Pershing, the firm has spent the past 12 months preparing the runway for market infrastructure changes such as T2S, as well as other regulations that result in changing requirements of banks and broker-dealers.

"There are infrastructure changes and regulatory changes where banks and broker-dealers have a longer-term strategic direction towards outsourcing and clearing with the provision of research and settlement," says Scott Coey, Pershing's director for institutional broker-dealer services.

"When T2S starts harmonising the European settlement landscape, the outsourcing of operational elements will follow, especially after 2016 when the major markets (ESES markets and Germany) will move to the T2S platform.

T2S will address capital and risk management requirements and settlement harmonisation across T+2 markets in Europe. "Across Europe there are 15 or 20 CCPs (central counterparties / clearing houses), with different credit requirements," says Coey. "T2S is one platform, harmonising credit and settlement requirements across a group of markets [in Europe] as opposed to a fragmented regional model, which drives the costs of pan-European trading up and brings additional risk and capital requirements. [This harmonisation] brings opportunities for mid-tier brokers and domestic brokers –to enter new markets.

In addition, Basel III will require banks and broker-dealers to put up extra capital. "The challenge is with that capital not being used to invest in new markets that leads to the conversation of unbundled outsourcing of clearing and settlement around the move to T2S and T+2," says Coey.

There are conversations around Markets in Financial Instruments Directive II (MiFID II) and the additional requirement for clearer reporting to the U.K. Financial Conduct Authority (FCA). MiFID reformed the equities market and MiFID II will introduce more transparency around other asset classes, e.g. fixed

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Annalisa Bicknell, BNP Paribas Securities Services

income and other types of trading such as high frequency trading. "In terms of transaction reporting, 25 fields currently need to be reported. Under MiFID II, this can increase to 90 fields. To get that right, you have to build and enhance your reporting," says Coey.

According to Coey, Tier 1 banks are having more strategic conversations and looking for strategic outsourcing partners in relation to T2S and other regulatory changes.

"The mid-tier brokers are moving a lot quicker now. They see regulations driving the cost of capital and the opportunities that T2S can bring: access to more markets without ascending costs to do so. It's a matter of what their USPs are. What are the pieces you would outsource where you don't add value? What are your key differentiators from research to execution? With the unbundling of the cost of research from the costs of doing a trade, sales research is becoming a niche market where brokers can make a difference."

Alternatives seeking alternatives

Amidst these regulations, buy-siders are looking to turn fixed costs into variable costs. "They want to focus more on the management of money and less on infrastructure and technology," says Samir Pandiri, executive vice president and CEO of Asset Servicing at BNY Mellon. "In the last five years, clients have had to be aware of and interpret many new regulations. They have to spend money on technology to implement these changes while staying focused on key businesses that they want to be doing in the next five years."

As buy-siders want to focus more on money management, and with the growth of alternatives, BNY Mellon saw a gap in the private equity and real estate space. Deutsche Wealth & Asset Management outsourced its real estate fund administration to BNY Mellon in January.

"Eighty percent of hedge funds have some portion of their back and middle office outsourced. But in real estate only 15-20% of the market is outsourced. There are lots of fundamental business pressures pushing people to outsource. Deutsche is an anchor client for us. They wanted to focus on real estate assets and be less focused on the operational elements." As such, BNY Mellon has invested in a platform to service real estate alternatives. Though customisation comes not in the core platform but in how the client uses the application to fulfill their business needs, says Pandiri.

"We're going to see more clients globally that invest in real estate, not just in Europe and the U.S. where the trend has been," he adds. "As regulations continue to change, that will drive more complexity. Managers will need a partner with scale – a provider who can support them as things become ever more complex."

However, Pandiri notes: "We're not going to go after every opportunity but rather focus on larger clients that already do business with BNY Mellon, leveraging the top 75 to 100 names."

Creating the target operating model

HSBC's Clive Triance, global head of sales and business development for Banks and Broker-Dealers, also observes that banks and broker sub-custody clients are looking at their costs and whether they can find solution providers to serve functions such as account operating and third party clearing. "We're definitely seeing a lot of interest in the account operator and third party clearing space and longer term we will see more interest from global custodians and brokers in that space with new regulations such as UCITS V, which will drive them to look at their footprint and how they can change their model. Those banks and brokers take transactions once they've originated them and enrich them. There's a lot of post-execution and pre-settlement work before they send it to settle and then create sub ledgers and general ledger once the transaction is complete.

"So when you look at that whole life cycle of a transaction they are running quite a lot of technology. There's an overlay between what custodians actually do at the coal face with the CSDs in country and what the banks and brokers are doing themselves in-house. There's a huge regulatory change and the cost of replacing old with new technology is undesirable and unsustainable. That creates the interest among banks in getting a third party to do some of that outsourcing of trade lifecycle management."

According to the technical arrangements behind outsourcing providers, portfolio managers need to work out at which point they want to hand over their trade to a third party. For example, while transaction cost analysis (TCA) is a calculation of the total cost that accrues around the execution of transactions, in the U.S., the measurement of a TCA captures some things but not others. "The TCA doesn't necessarily capture everything of the lifecycle of a transaction from post execution to settlement so when customers start to look at outsourcing they really have to understand their unit costs today and then they have to look at their provider and they've got to ensure they measure it like for like, otherwise they think they're going to move to a new provider for services but when they do they find they're doing different things to the ones they wanted to outsource," says Triance.

"In creating the target operating model for the customer, there is a lot of work to be done in understanding who is doing what in the lifecycle of the transaction and once you have truly done that you can understand your unit costs. To do that you need to understand what your IT costs are and how they change if you move. Then you've got the physical movement of stock at the CSD versus the cash treasury costs involved in that, and that's where you get to your true TCA if you've done all that work."

Triance notes some of the outsourcing providers target large lift-and-drop outsource deals that are highly complex and cover all the functions post-execution that a bank or broker does while others are prepared to create tactical solutions, which address the customer's most pressing needs.

"Some outsourcers want to do everything in one go," he notes. That makes it hard for banks and brokers to make a decision because of operational risk, and the bigger the deal, the more complex it is and the more operational risk you run. Tactical solutioning allows firms to dip their toe in the outsourcing pool before doing more complex deals"

"The outsourcing services industry can only expect to receive the correct level of regulatory oversight and we at HSBC welcome that."

Dear CEO, what has changed?

It has been just over two years since the Financial Conduct Authority (FCA) issued a letter to the CEOs of asset managers in the U.K. saying that as a result of their thematic review, it did not think the contingency for the failure of a provider was robust enough to protect the end investor. It asked the industry to find solutions for the event of provider insolvency. "During the first few months of 2013 there were meetings and providers gathered to listen and contribute. "By the end of March we realised there was lots of talk, but not solutions," says Mark Westwell, Head of Client Management at State Street.

"Providers came to the conclusion that it's not going to satisfy the regulator and we can probably do something about this in terms of its impact to the industry."

"As regulations continue to change, that will drive more complexity. Managers will need a partner with scale – a provider who can support them as things become ever more complex."

Samir Pandiri, BNY Mellon

Providers worked collaboratively and came up with three areas of recommendation: work with clients on governance and oversight, exit plans and on standardisation. "The regulator said our recommendations were on the money," says Westwell. "We agreed that to make it worthwhile we have to get an equal number of asset managers to moderate and facilitate and come together as an industry body that would work for the regulator, industry and investors." And so the Outsourcing Working Group (OWG) was born.

In September that year the OWG received conclusions from its workstreams, enabling it to form a consensus view.

Westwell says: "Almost a year after the FCA challenged the industry it issued a paper on its thematic findings. They referred to our work as the guiding principles for the asset management industry, which they could use to put in place their own governance and oversight exit plans in order to comply with the requirements of the regulator.

"At that point we stepped back and got back into the business world to support our clients."

In January 2014, the regulator met with the OWG to wrap up the work of the group. "They said you've got to go away and apply this to your individual

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Clive Triance, HSBC

asset management businesses," says Westwell. "So throughout 2014 the challenge was what are they doing in terms of their understanding of outsource provisions."

"The FCA didn't want hard and fast but best practices for the business model," says Matt Davey, head of Asset Managers at State Street. "Previously they were looking at KPIs and service levels. Now they're taking a risk management approach – looking at the risk and the mitigants involved."

Even though this was a U.K. based issue, many global managers have U.K. arms and found themselves engaged with regulatory calls globally. "Some were international managers but were compliant in the U.K," says Westwell. "So there's been a huge amount of interest, particularly from the U.S." Other countries such as; France, Germany, Australia and Hong Kong all have similar regulations on outsourcing. The Central Bank of Ireland issued their own Dear CEO Letter. "As a result, some global asset management groups are looking across their service providers and, rather than do it piecemeal, they are using the U.K. as the benchmark for their oversight of global operations," adds Davey.

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France, Germany and Ireland also issued their own form of a "Dear CEO" letter. "Some global groups are looking across their operations and they are using this response as the benchmark," adds Davey. "So we are seeing more firms with a service provider management role and greater emphasis on the skill that person needs to oversee service provider relationships in multiple locations."

Westwell notes that asset managers have brought about more consistency in their models as a result of the work done. "They've enhanced their models and had some form of oversight and governance in place, but it was to varying degrees," he says.

Asset managers to go utility shopping

In both Europe and the U.S., new onerous regulations are driving demands for outsourcing collateral management processes. Under the European Market Infrastructure Regulation (EMIR), asset managers will have to begin central clearing from 2016. With the BCBS-IOSCO margin rules, they will also have to margin their counterparts for swaps traded outside of the clearing house. For many, this is a completely new task, and an enormously complicated process.

"When you start to worry about eligibility criteria, haircuts you have to manage, the calculation of margin, etc., it will all be very complicated," says David Field, founder and managing director of The Field Effect (TFE), a clearing and collateral management consultancy. "The driver (for asset managers) is cost avoidance and complexity avoidance.

For custodians, this seems the perfect opportunity to expand their collateral management services and cater to their clients' outsourcing needs. However, to an extent, this is not entirely true.

For example, in the cleared world, assets from the asset manager will be catered to the clearing house via their clearing broker or futures commission merchant (FCM), but because of EMIR, the central counterparty clearing house (CCP) can only allocate those assets to custodians that also operate a central securities depositary (CSD). Excluding the international CSDs that perform both custody and settlement, such as BNY Mellon, Clearstream and Euroclear, asset managers have to really think about having the ability to retain their assets when choosing an outsourcing provider.

"As an asset manager you need to be absolutely sure where your and your clients' assets are," says Jon Thompson, COO, Zurich Investment Services.

In order to meet these changes, the industry is seeing a new wave of utility models from a variety of sources, not

"The providers have worked with their clients to enhance their models. At State Street, we can provide a model so that anyone who partners with us starts with a base of 20 models that they can take different components, as appropriate to their outsource model. So it's raised the bar in the standards that were already there that were being executed to varying degrees. It's made it more consistent around common forms, but there are still variables in place that are appropriate to asset managers."

Global Custodian hosts a roundtable discussion on outsourcing.
L-R: David Field, The Field Effect; Jon Thompson, Zurich Investment Services; Raymond McCabe, OutSET Global and Janet Du Chenne, Global Custodian

only from custodians but from brokers, software vendors, commercial ventures, and equity-backed start-ups. One major utility model on offer is the Depository Trust and Clearing Corporation's (DTCC) Margin Transit Utility (MTU), which will enable straight-through processing of margin calls, and Euroclear's Collateral Management Utility, which will address the global challenge of sub-optimal collateral allocation and mobility.

As well as this, major banks are forming consortiums to create a collateral utility, such as Goldman Sach's "Project Colin", that will standardise the bilateral collateral exchange process. Furthermore, a number of software vendors are producing their own collateral management utility and are hoping to team up with the banks.

But with all these offerings, survival of the fittest could come into play.

"The outsourced providers in the collateral space are quite fragmented and still emerging. I liken it to an ecosystem with a real accelerated evolution; so some of the new species of outsourcers won't survive, others may fall at the wayside, some may have a great offer but are not commercially viable, etc.," says Field.

There is also the concern that if the asset manager selects multiple providers for their collateral management, then how will they be able to keep control of their assets when they are constantly moving. Furthermore, asset managers, particularly the ones that are new to collateral management are facing the challenge of who to back. Do they go with an established institution or do they go with the new utility that has sprung up because of recent changes?

"With lots of new providers it's difficult to know who will still be there in three years' time. In some ways, it's probably more difficult to make that choice now than in a mature space where there are established providers and their abilities are well known," says Thompson. "I will be more nervous betting in the new space than in the mature one."

On the other hand, the new ventures should not be ruled out completely.

"Custodians don't have a reputation of being fast moving, innovative or cutting edge," adds Field. "Some software vendors are much faster, more agile, and sit on technology assets already so they can re-purpose them and create a processed outsourced capability. So the custodians need to watch out."

So here's the choice: do you want a big brand name that might take a while but get the job done, or do you want someone that is more agile, can move at your speed, but is slightly riskier? ■

– *Joe Parsons*

On exit planning, getting the contract done was a major undertaking and the exit schedule was just one part of the documentation. "The OWG defined a more common look and feel towards the components within an exit schedule," says Davey. "There was also the conclusion that the exit plan was not conducive to a fast transition over a weekend. Crucially, you cannot deal with an emergency exit over a weekend. The OWG concluded that, whatever happens, you have to do all the same things to move a piece of business, and that takes time. However, you can prepare for that transition in a number of ways which are in the OWG recommendations."

In relation to the standardisation of outsourcing templates, Davey argues standardisation involves a complicated set of processes and services and it would be difficult to introduce standards for outsourcing across the industry. "There's also a debate about whether that's what asset managers want, because that's how they get their competitive advantage," he says. "So standardisation required much more work than everything else, because it's a service industry where we have a lot of providers of outsourced relationships. The problem is not so much about standardisation, but more about the people,

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Mark Westwell, State Street

the skills and complexity of operations: it's not like the standardisation debate with custody messaging."

Going forward, outsourcing will continue to be driven by regulatory aspects. "With AIFMD there are depositary functions, there is a risk management function and a regulatory reporting function," says Davey.

"There are requirements that clients would not typically have in-house, but it's a requirement from the regulator that they provide those services."

"I think there is a general challenge for the asset manager and the data required to respond to regulatory changes and for firms to maintain and use data to meet the regulatory reporting requirements."

MiFID II will continue to challenge the industry as well, with services like trade execution and performance being outsourced.

Westwell says: "With heightened regulation the asset manager will continue to renew their target operating model where you could have an asset manager that's acquired four other lines of business with five different operating models. They may take the opportunity to ask 'What can we do ourselves, and rather than consolidating once would it be better to consolidate as much as possible?' So we are seeing more firms with a service provider management role and greater emphasis on the skill that person needs."

The future: operational alpha

This complexity of front-office relationships will be another driver of outsourcing. Ann Doherty, managing director at J.P. Morgan, says asset managers want to capture new money but the complexity, particularly the relationship with distributors and the ability to handle those relationships, drives the outsourcing of transfer agency, accounting and the middle office.

"It's the complexity of end-client relationships that makes distribution support a driver," she says. "For our clients, transfer agency is the most important relationship as an adjunct to custody and fund accounting. We've invested heavily in a new transfer agency system for Europe with Multifonds. Phase 1 of the transition is complete, and further transitionings onto that platform will occur later in the year and into the following year."

"We are seeing a lot of asset managers review their accounting platforms and middle office," she says. "But deals are very complex and it can take time to switch from one provider to another.

"We help them design operating models. These transitions can be difficult to do because you're undoing 15 years of operational legacy; but in the search for new assets, things are becoming more complicated, for example, helping to launch a master feeder."

Sanjiv Sawney, Citi's head of global custody and alternative investor services, cites asset segregation as an important driver for financial institutions. "They need to ensure the assets given to their custodian are appropriately segregated at the lowest levels".

The need for data is also growing in importance. "Clients are having to look at their product offering to provide transparency to the end investor, as investors are asking for more information," says Sawney.

Additionally clients are reviewing their product offering to address the continuously changing regulatory environment.

"Long only and hedge managers typically have their custody, transfer agency and middle-office operations outsourced. I would expect more outsourcing in the private equity and real estate space, as these managers look to cope with the investor needs and regulatory changes in a cost-effective manner."

With component based outsourcing set to increase, this paves way for a new ecosystem of service providers who are more agile and can provide more bespoke solutions. Not all will survive however. Utilities are also increasing in number ahead of the regulation for OTC derivatives clearing, capital adequacy and compliance.

Amidst this, outsourcing 2.0 has not fully grappled with the issue of control and oversight but still relies on issues being treated on a case-by-case basis between asset manager or pension fund and their provider. What is certain is that as a result of regulatory intrusion, component outsourcing and unbundling will continue to dominate the landscape in years to come. ■

– *Janet Du Chenne*