# BUILDING A SUCCESSFUL INVESTMENT OPERATIONS OUTSOURCING PARTNERSHIP

BNY MELLON

# INTRODUCTION

In the last few years, BNY Mellon has seen a shift in the approach to middle and back office operations outsourcing and our conversations with clients have, as a result, taken a new direction. Investment managers are re-evaluating how their operations teams can sustain future demands, whilst also rationalising fragmented arrangements that have been built up over time.

BNY Mellon strategically assesses what is core and non-core to the client's operations before proposing what types of outsourcing might be considered – ranging from technology only to a full business process. The decision to outsource still follows familiar evaluations of the systems underpinning an operation and the links between different functions. In the past, the assessment of how the outsourced operation will be governed, managed and measured might have been lower down the consideration list. Today, after surmounting the inevitable challenges of implementation, defining the governance around an outsourced arrangement is fundamental to understanding how it will work and the benefit it will provide to the investment manager.

In addition, a laser sharp focus as to who has ultimate responsibility for an outsourced relationship is required after the United Kingdom Financial Services regulator recently challenged all the CEOs of Asset Managers[1] to review the level of governance they had in place to effectively monitor their third party service provider(s). Whilst this review was instigated by the UK regulator, it affects all global firms with UK investment management offices and it is expected that other regulators across the globe may ask similar questions.

In this recent review of investment managers' outsourcing arrangements[2], the UK regulator reminded investment managers of their obligation to apply adequate oversight of their service provider. With specific reference to governance and control, the investment manager should have measures in place to make sure critical activities are monitored and they should have oversight tools to address the risks identified in a timely manner (e.g. pricing errors).

Failure to effectively oversee their service providers could also result in poor outcomes for customers and reputational risk to their brand. Whilst investment managers have historically relied on their service provider for quality checks, the robustness can be reinforced when investment managers equally have substantial in-house expertise to verify that the service provider is at an acceptable standard. The Outsourcing Working Group (OWG), an industry body aiming to develop best practices for investment managers, produced a paper in December 2013 on the "Key Principles of an Oversight Model". The OWG report recommends four principles to follow when selecting or establishing a relationship with an outsourcing provider. For the purposes of our discussion, we focused on the oversight element of the OWG's report - a key obligation and responsibility of the investment manager.

We consider how vendor management has developed beyond traditional contracts, Key Performance Indicators (KPIs) and operational Service Level Agreements (SLAs) management. When middle office functions are outsourced or new technology solutions are implemented, advantage can be taken of available tools that can help solve traditional problems whilst providing increased transparency. The key challenges we have sought to address and highlight include:

- The importance of data quality
- The oversight and governance of data dependent services
- The methods of monitoring data performance
- How service providers can assist the investment managers with their oversight responsibilities

We focus on each of these areas with the aim of demonstrating how important they are to the overall long-term partnership between the investment manager and their outsourcing provider.

# KEY CONSIDERATIONS FOR A RELIABLE PARTNERSHIP

Now that the regulators have put CEOs under the spotlight, choosing the right investment operations outsourcing provider has never been more important. It is essential for investment managers changing their middle office business model to select an outsourcing partner with whom they can develop a long-term partnership. Future success is more likely when the relationship is built on full transparency, trust and honesty. These elements are mutually beneficial to both parties and will allow them to grow and flourish together, whilst overcoming the inevitable hurdles along the way.

Trust takes time to develop and will only be sustained through open communication and transparency. Successful outsourcing providers have established processes that enable the information to flow to investments managers that relate to the outsourced function; giving investment managers a sense of overall control and governance so that they can get more involved as and when they need to. Tools such as real-time interactive dashboards are more frequently being used to fulfil this need for real-time information.

# RECOGNISING THE IMPORTANCE OF DATA QUALITY

The need for quality data is not a new phenomenon - it remains central to performing middle office functions. Whether helping to settle trades, providing start of day cash balances to an Order Management System, applying corporate action instructions or comparing a portfolio's performance to its benchmark, the investment manager requires accurate, timely data that they can rely on. Since front office decision making is wholly dependent on data (both market and processed), quality is critical. Outsourcing firms can no longer claim to have solid data without demonstrating evidence to that effect. Decisions based on inaccurate data may lead to losses, reputational damage and/or other unintended consequences. The data must, therefore, be scrubbed and validated through proven quality controls before being delivered.

The provision of data on a timely basis is another key component to building trust. Data may be required at a prescribed time of day to perform specific functions, as well as being required for maintaining oversight. Markets do not pause and neither does the investment manager's process. It is imperative that the outsourcing provider adheres to the terms of the SLA for the delivery of data.

Consistently providing timely, high quality data that can be used to meet diverse requirements is crucial. The right provider will meet these expectations and in so doing validate the investment manager's original decision to outsource.

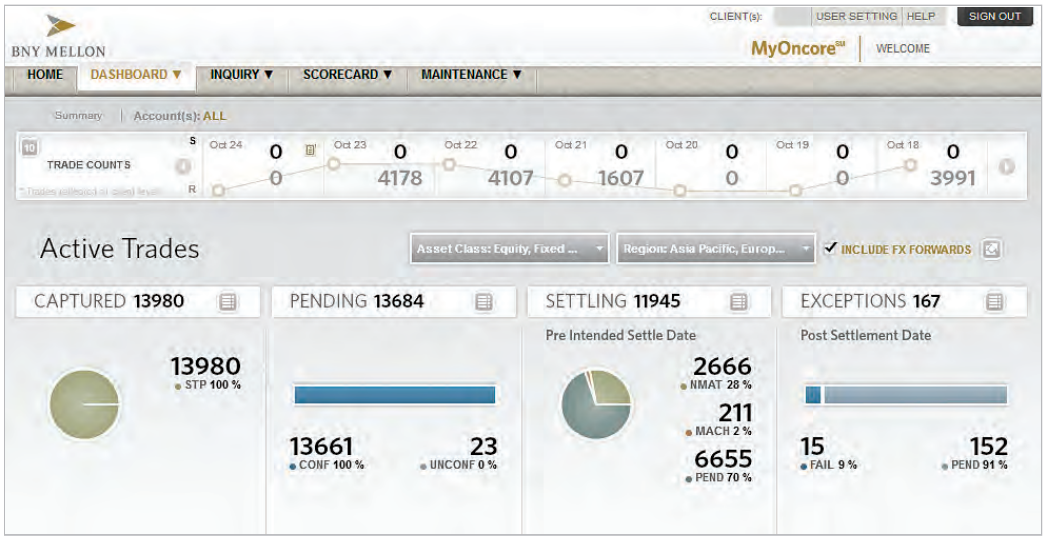
# OVERSIGHT OF KEY DATA DEPENDENT SERVICES

There are numerous investment operations outsourcing services that consume quality data. The key functions are:

- Investment Book of Record
- Cash Management
- Performance Measurement
- Collateral Management
- End Client Statement production
- Corporate Actions Processing
- Custodian Reconciliation
- Trade Matching/Confirmation
- Client Billing

# BNY MELLON'S MYONCORE

Knowing the level of complexity that exists in outsourcing investment operations, BNY Mellon has created the MyOnCore tool to give clients greater visibility and oversight of their operations. We are continually enhancing this tool to help you effectively manage your data.




Using our tool as a guide, we have detailed the types of information clients expect to extract from a dashboard. The information contained in these tools help identify the root cause of operational problems and provide an indication of areas that need improvement.

**Failed trade analysis** - Typically, outsourcing partners provide notification of failed trades. Optimally, they should provide supporting metrics to quantify trade failures and the reason for the failure. For example, an investment manager may want to know:

- The most common reasons for failed trades globally or in a specific region for a particular asset class
- Trends around matching success rates and timeliness in particular markets

**Broker service ranking** - Brokers should be ranked using quantitative characteristics that enable the client to hold open discussions that should result in increased service levels. This information is needed to identify the top and bottom performing brokers. Examples of queries could cover:

- What are my straight-through processing rates?
- How many trades were within the investment manager's tolerance limits?
- How quickly after trade execution was the broker instruction received by my service provider?

**Reconciliation breaks analysis** - Simply, reporting a stock reconciliation break of 1,000 units, for instance, is insufficient and does not provide the investment manager with real insight. Outsourcing providers should produce detailed and specific information about reconciliation breaks to ensure the investment manager understands the efficiency and expertise of the operation, for example:

- How long has the break been outstanding?
- How many similar type breaks are attributed to the same custodian?
- What is the total value of the break?
- What is the priority of the reconciliation breaks?
- What actions will the outsourcing provider take to resolve the situation?

**Collateral management** - The outsourcing firm should report more than just an investment manager's total exposure. Other valuable information the investment manager needs include:

- The number of collateral calls and recalls
- The number of delivery and returns
- All disputes and the total value disputed
- The client's exposure by counterparty or by product

**Delayed vendor security data** - Merely informing investment managers via email that the latest vendor security file will be delayed gives the investment manager very little information to address the issue. The client is more interested in when they should expect to receive the late security file and what remedial action will be, or has been, taken. With this information, the investment manager can then make an informed decision on whether to wait on the data or alert their front office that the start of day detail is stale.

**Receipt and distribution of securities** - A report that simply states, for example, that 100 securities have been received from a vendor and distributed offers little value. More detailed data must be provided, such as:

- The date the provider took receipt
- Whether it was late or on trend
- The time it took to scrub and validate the security records
- The type and number of errors identified
- Whether a vendor repeatedly provides data with the same errors
- The time it takes to provide clean records to target systems

Outsourcing firms that do not provide these tools lack transparency and function like a black box.

# BEST METHODS OF MONITORING DATA PERFORMANCE

In addition to monitoring the individual business services, dashboards can also be used to govern the overall outsourcing relationship. More effective risk and compliance monitoring provides early warning signals and triggers remedial action. Traditional KPI reviews are too infrequent for today's environment. Online tools should be intuitive and easy to use, be continually enhanced, be enabled to receive frequent updates and clearly demonstrate the value of the services provided. Moreover, they can be used to enhance other functions, such as cash management and collateral processes.

Measuring the competency of your outsourcing provider helps you assess whether your partner is nimble enough to respond to your immediate business needs and has the capacity to grow with you over time. This validation is the single biggest factor in improving trust and strengthening our relationship.

# CONCLUSION

Modern online tools are replacing traditional file based reporting as a primary means of exchanging time critical information across organisations to enhance and improve the flow of information. It is important to constantly evaluate whether the tools provided by your outsourcing partner are providing enough information to help you monitor, manage and govern the relationship. After all, whilst you have outsourced certain functions to a third party, the ultimate responsibility for these functions remains with you. Keep in mind the old Russian proverb (later made famous by Ronald Reagan) "Trust but verify".

Source: http://www.fca.org.uk, The UK Financial Services Authority has been split into two regulatory bodies, one of which is the Financial Conduct Authority.

Investment Management Association; http://www.investmentfunds.org.uk/

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## ABOUT BNY MELLON

If you are interested in understanding how BNY Mellon OnCore oversight tools work or how we perform as an outsourcing firm and you are an existing client, contact your relationship executive or service director. If you do not have a relationship with us, please contact the BNY Mellon Outsourcing team.

[1] http://www.fsa.gov.uk/static/pubs/ceo/review_outsourcing_asset_management.pdf

[2] http://www.fca.org.uk/news/thematic-reviews/tr13-10-outsourcing-in-the-asset-management-industry

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12/2013

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