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More than a deal:

Addressing the operational challenges
of outsourcing for asset managers*

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Powerful demand and supply side factors in the asset management industry have led to a significant increase in the extent of outsourcing in asset management. Crucial in facilitating this has been service providers' willingness to 'lift-out' systems, people and processes by acquiring existing asset managers' operational platforms. This enables asset managers to generate shareholder value while avoiding complex and risky integrations. Initially service providers have been prepared to pay an upfront premium as a means of market entry, but will this continue? And how should asset managers address the complex issues and mitigate risks inherent in an outsourcing partnership so that it is both a good deal now and a continued success over the next 7-10 years through changing circumstances?

The focus of this document is on outsourcing in-house operational functions, covering retail and investment operations, to a third party provider through 'lift-out'. This has been a notable phenomenon in the UK, with much deal activity as many of the industry's best known asset managers have outsourced substantial parts of their operations. Typically, the asset manager realises value and minimises risk by lifting out its existing platform to a third party, usually followed by a second wave migration onto the service providers' platform. It should be noted, however, that many of the challenges outlined will equally apply to the transfer of outsourcing services from one provider to another.

Demand and supply factors

The catalyst for outsourcing has come from a host of strategic, financial, operational and technological changes. Competition for assets and greater attention to investment performance is driving asset managers to re-focus on their core competencies of product development and investment performance, and to consider whether capital resource deployment supports this. For the asset manager, maintaining or increasing profitability in turbulent markets has encouraged better matching costs to revenues with a business model that migrates from a largely fixed cost base to a more variable cost structure.

Concurrently, operational and technological change make asset managers question the additional development and refresh costs needed to maintain competitiveness. Customers want a consistently-delivered, high-quality service at an ever-reducing price. For asset managers with more complex products, industry best-of-breed technology is crucial. Simultaneously, the cost of regulatory compliance and disclosure keeps rising. The lack of historic IT investment looms large, and sharing systems development becomes more compelling, with external requirements such as Basel II, IFRS, the EU Savings Directive, and UCITS III.

Meanwhile service providers, particularly global custodians, have been looking beyond existing markets to maintain their growth rates. They see the economies of scale available through sharing fixed infrastructure costs across a number of asset managers. There are also economies of scope through vertical integration and bundling investment operations and fund accounting with custody provision, hence providing the additional services at a lower marginal cost to the same customer.

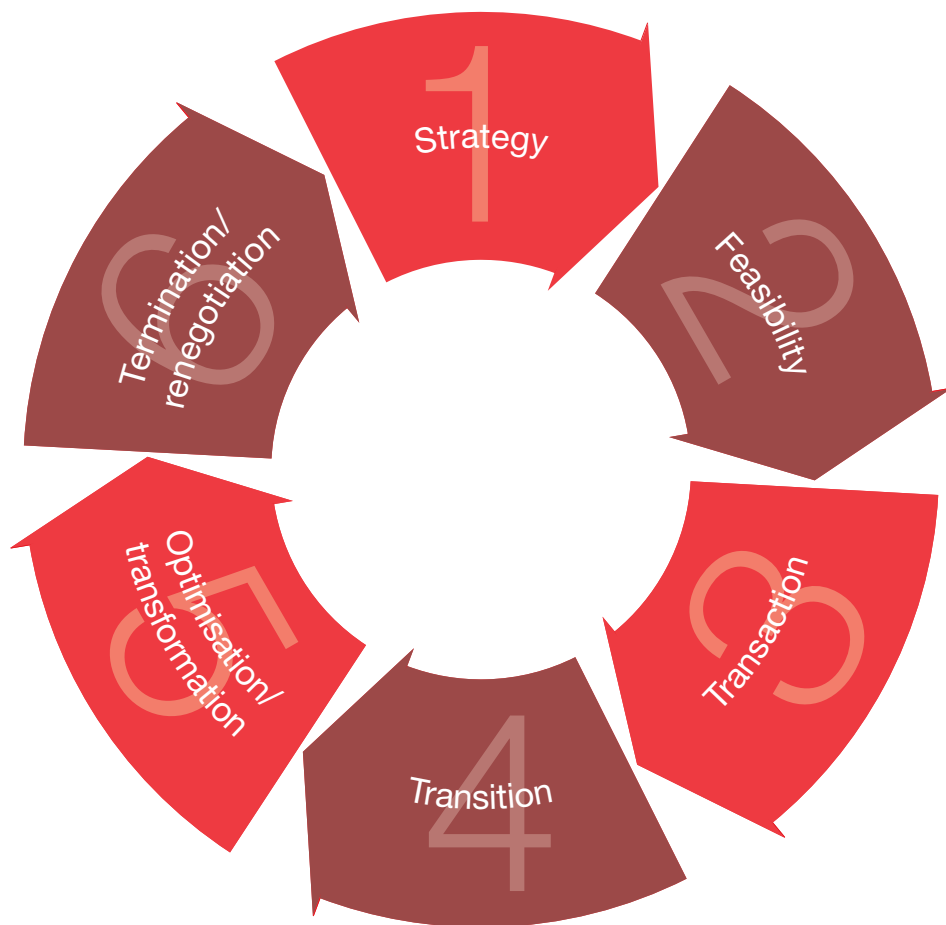
However, the process to achieve outsourcing is high risk and devours management time, even if a lift-out has less potential for failure than immediate migration to a third party platform. Often, too much emphasis is placed on 'doing the deal' when outsourcing is a long term project needing substantial ongoing efforts both pre- and post-deal to deliver the potential benefits and maintain an optimum partnership.

Flexibility and control, new product development and speed to market will all be impacted by the deal struck. With both asset managers and service providers facing consolidation, the merger/acquisition of one or both parties is highly likely over a ten year span, so the contract must adequately consider and mitigate risk as to how each will evolve over the short and long term. It is strongly advisable to consider these key questions upfront, through a highly-structured process that considers different scenarios and draws on evolving industry norms to reach best practice and avoid others' pitfalls, in order to maximise benefits and minimise vulnerability at the negotiating table and later.

PricewaterhouseCoopers' outsourcing lifecycle

At PricewaterhouseCoopers we have developed and successfully used our outsourcing methodology to work with clients in all sectors, including supporting significant outsourcing transactions in the asset management business. Our experience has been that those organisations that get the full benefits of outsourcing and minimise the risks do so by following a clear six stage lifecycle that takes them from the initial strategic decision through the scoping and definition of requirements, selection of a service provider, transformation of the business and prepares them for eventual termination or re-negotiation of the contract. While PricewaterhouseCoopers can help in any of these stages, we are able to add the greatest value to clients when we are involved from the beginning, helping the client to validate their strategy, then structuring the transaction – along with any financial, legal, regulatory and tax constraints – and executing it, transitioning and optimising the service, all the while remembering that eventually the relationship will either end or need to be renewed. Quite simply, if the groundwork is laid correctly in each stage, the ability to anticipate and effectively handle the inevitable hiccups or more dramatic changed circumstances increases enormously.

Additionally, a clear communications strategy for both internal and external stakeholders linked to the complete lifecycle will help set realistic expectations and increase the success of the process.



Case Study¹

Outsourcing retail operations: Threadneedle Investments

Threadneedle Investments was created in the early 1990s and is now owned by American Express; it has £63 billion in assets under management.

The retail operations lift-out was prompted by identification of a business issue. First apparent in Germany, but increasingly evident elsewhere in Europe, the retail business was being disintermediated with growing use of aggregation platforms. In 2004, 40% of Threadneedle's business was aggregated into platforms, but over ten years this was expected to rise to 90%, with non-aggregated holdings falling to a third its current level. Threadneedle decided it didn't want to manage the reduction of the administration platform and resources which would be 'death by a thousand cuts'. They felt that their impressive single transfer agency (TA) platform across Europe and scalable capability with 235 people including in multi-lingual call centres, could prove very attractive to the right partner. They adopted a very structured approach to finding this partner with lots of independent Q&A. In a ten year lift-out deal worth \$100 million, Bank of New York was chosen.

A key aspect of the deal was ensuring that any path chosen stayed P&L neutral in year one, and be earnings enhancing thereafter. Achieving P&L neutrality meant considering issues such as:

1. VAT (crucial, as it increases the cost)
2. Write-off of undepreciated assets
3. One-off transition costs
4. Ongoing oversight costs.

Also important was building in an ongoing performance improvement programme for the provider.

“Outsourcing success is a combination of decision, approach, monitoring and managing. In eight years time, will it feel like the right deal with the right people?”

Crispin Henderson, Threadneedle's Chief Operating Officer.

¹ The quotation and case study come from the May 2005 PricewaterhouseCoopers' Investment Management Forum.

Case study¹

Outsourcing investment operations: F&C Asset Management

Too much outsourcing happens by default; a major part of F&C Asset Management's success has been outsourcing by design in support of strategy. The firm known as Foreign & Colonial in 1988 went through a number of mergers and acquisitions, and when owned by Eureka (2000/1), consolidated investment operations from disparate firms into a single hub (in London). With a highly sophisticated and benchmarked platform already, they sought global capabilities (now and for the future). Could anyone do it better than they did? They looked to an outsourced solution for €60 billion in pension fund administration to move to a single best-in-class IT platform and raise administration standards and quality. The key drivers were moving fixed costs to variable, as well as further reducing the cost base and migrating operational risk. However, as this outsourcing search was coming to fruition, they also identified a merger opportunity with Friends Provident (ISIS), which was also going through outsourcing investment operations. As this merger proceeded with 16 workstreams, among the most significant were outsourcing and IT (as well as HR). This led to the selection of a single provider which could best support the merged investment entity, with Mellon winning out because of its strong European platform.

“If no one knows you’ve done it, outsourcing is a success.”

Tony Tomlinson, F&C's Chief Operating Officer at the time of the case study

¹ The quotation and case study come from the May 2005 PricewaterhouseCoopers' Investment Management Forum.

Stage 1: Strategy

PricewaterhouseCoopers view

Outsourcing is first and foremost a means to an end of supporting a firm's strategic plan; it is not an end in itself. Outsourcing can support business strategy and, through having clear objectives and measurable benefits, may achieve cost reduction, improved service quality and a host of other business benefits.

From this business strategy stems identification of options available. This needs to start quite broadly, looking at country configurations, whether single or multiple provider, removal or smoothing of high IT investment costs, etc. Initially, and throughout the process, it is necessary to assess (and inform) customer and stakeholder views, including employees who are likely to be uneasy about anything they perceive as a job threat. Most important will be building an accountable team with a high level of executive commitment as the management time needed is always greater than anticipated.

Client view

We knew there was a better option than running down the valuable administration platform and resources so we set out to capture, preserve and build on the value we had created in our administration services.

Asset management houses need to be run and justified as businesses, with constant cost reduction efforts, and outsourcing has been a major strand of our success. In-house, we took it as far as we could. We did not set out to outsource, but outsourcing was the means of furthering out strategic objectives.

Stage 2: Feasibility

PricewaterhouseCoopers view

Outsourcing should be viewed on a 7-10 year horizon. It begins with building a business model and clear business case looking at true current and future costs and sets very clear and achievable objectives. A baseline of existing cost and service levels (what actually is being delivered!) is a starting point. However, future costs depend on future requirements and implications, which necessitate robust scenario planning as to how the industry will evolve and what the firm's current and future market capability is.

Again it is critical to address management's capacity to deliver, both in terms of time and focus. A useful question to consider when looking to outsource is, 'What are you not going to do?' Equally important will be to establish what will be left once outsourcing occurs (for example in the case of a lift-out) and how that will connect to the business.

This stage needs to look at the outsourcing market, the service providers and the commercial models that drive the relationships. It is then necessary to assess and benchmark the options by using the baseline to appraise potential service providers and relationships. This is usually done by setting up screens or filters to work through the options and move forward with a viable number of suppliers (perhaps as few as two) to the transaction stage.

In addition to reducing the number of suppliers, this stage sets achievable targets in the context of the outsourcing relationship and defines what constitutes value for the organisation, as well as makes explicit the full cost implications of the changes that will take place.

Client view

One of the most significant issues was taking three senior people out of their jobs for ten months so they could find and deliver the right outsourcing solution.

We wanted to be the cornerstone, where the provider's European strategy would falter if the transaction was unsuccessful. We concentrated on the strategic business alignment with the provider; too often deals are swayed by personalities, but people can move.

Stage 3: Transaction

PricewaterhouseCoopers view

The aims of the transaction phase should be to minimise risk and balance the priorities and components of value between financial benefits, quality of service and impact on people. A robust deal process using M&A disciplines is needed and the best deal will be achieved if competitive tension between providers can be maintained for as long as possible, with professionally run negotiations. Nevertheless, the deal must be commercially viable for the provider to be successful in the long term.

The transaction stage needs to cover all deal points and contractual points and consider all major contingencies. Taxation (direct and indirect) and regulatory implications of transferring a going concern business to a third party and buying the service back can be important in determining structure. The negotiated benefits need to be locked in to ensure they are not 'renegotiable' by the provider post contract, for example, through reducing service levels to achieve cost savings. There needs to be clarity of scope and business requirements that service providers must continue to deliver once the function is lifted out, including identifying interfaces and dependencies between functions and third parties. Communication is important, with effective consultation with staff, both those transferring and those remaining. Attention must be paid to managing expectations of internal and external shareholders (including parent company, clients, regulators and the wider market).

So the level of detail as to how the partnership will work going forward means the negotiations must cover not just financial issues but scope, service levels, penalties and exit strategies. The governance and oversight mechanisms must be in place before the deal is finalised. A realistic look needs to be taken at how ready each party is to move to outsourcing.

Client view

We were very unusual in negotiating in great detail simultaneously with two providers BEFORE bringing in the lawyers to document the detailed deal. It was only once we came to the handshake contract and deal stage that we selected a provider and brought in our lawyer and the provider's lawyer (and then had them share an office to get the deal documented).

The transaction phase can be painful; we found it helpful to use an experienced consultant who knew terms of other deals and what motivated different providers. This middleman also meant that the eventual working relationship was not hampered by tough tactics taken during negotiation.

Stage 4: Transition

PricewaterhouseCoopers view

This stage is about the practical implementation of the deal. In a lift-out, it involves transferring ownership and management control to the provider while minimising business disruption.

This requires managing and achieving physical and logical separation including segregation of buildings, separation of IT networks and isolating new and old IT applications. It ensures clear and working interfaces between the asset manager and the service provider covering processes, data and issue management. The task of ensuring the stability of processes and working with the data will take double the time anticipated to get it right. IT and data interfaces must be made explicit and done correctly, not just bundled into existing process. Legacy systems need to be either decommissioned or mothballed, but the business may still need access.

Challengingly, new roles must be assumed as the asset manager needs to start behaving as a customer and manage and channel communications accordingly. The service provider needs to take effective management control of the function lifted out and ensure that the asset manager moves to an oversight rather than a management role of the function.

An important aspect is regulatory and compliance arrangements, particularly the extent of reliance on the provider's control functions and the level of secondary monitoring required.

This stage needs to establish ownership of and responsibility for the key transition risks including operational failure and non-delivery of financial benefits in the business case, ensuring that the service provider does not pass on costs of transition to the asset manager. The human resources implications of outsourcing are substantial and the impact on staff must be managed (both those remaining and those transferring) to mitigate against staff dissatisfaction, high levels of involuntary turnover or malicious acts.

A key challenge is managing the trade-offs in the timeframe for migration, balancing (a) the risk of service deterioration with (b) the need to impose a period of 'no change' to allow sufficient time to effect migration and achieve stability with (c) the requirement of both parties to progress and develop their business.

Effective oversight arrangements and performance management mechanisms, with sanctions for non-delivery, need to be made operational. These would include:

- Service levels and key performance indicators;
- Service credit or debit mechanisms;
- Step-in rights; and
- Exit criteria and mechanisms.

A key area to be addressed is putting in robust mechanisms to prioritise, schedule and manage change, e.g. due to new clients, new products, changing market conditions and volumes and ensuring that there is a clear basis for apportionment of development costs between parties. Specific focus is required on the initial period of the outsourcing arrangement where operational and connectivity issues are likely to arise and close cooperation of both parties will be needed to resolve these.

To keep commitment and morale, it is advisable to identify and deliver quick wins, for example at cost and service levels.

Client view

The transition phase should be working toward lessening the risk all the time, particularly operational risk and people risk – reputational risk will always be there.

The lift out should be incremental: 1) changing the management, 2) changing the location and 3) changing the platform/IT transition.

Our people who were lifted out were pleased to move from being the back office to being the front office.

The oversight by the asset manager requires considerable effort and needs to be led by someone of the right level/expertise (perhaps as qualified as the operations director).

Stage 5: Optimisation/ Transformation

PricewaterhouseCoopers view

This stage delivers the benefits of the partnership by making the cost savings real by achieving economies of scale and scope. The majority of these savings are typically achieved through the migration from the lifted out platform to the provider's strategic platform, coupled with ongoing efficiency gains. If offshoring is under consideration, it would need to look at scope of services, evaluation of potential locations, entity structure and optimum business model and taxation structures.

The transaction stage should have agreed how the asset manager and service provider share both any development costs and cost savings, and whether the asset manager has any veto rights over service provider plans.

There must be a continuing focus on the ongoing management of service levels and achieving the benefits forecast in the business case. Transparent cost and service benchmarking should be used to get a full understanding of progress. The monitoring tools agreed during the transaction stage must be operated on an ongoing basis but must adapt to changes in the operating environment and experience of the outsource arrangement.

The planned benefits are most likely to be achieved if the service definition and management tools used reflect the future target operating model, not the present. It is important for the asset manager to understand what success looks like for the provider.

A further priority is managing change requirements to ensure the business is future-looking and the outsourcing partnership is adapting to change. Clear communication channels, together with agreed mechanisms for sharing costs and benefits, are crucial. Furthermore, the asset manager must embed the behaviours of a customer-supplier relationship and not continue to act as owner of the function.

Client view

Monitoring needs to have a clear escalation process but some humility remembering how well it did or didn't work prior to outsourcing is always in order. Particular areas to address are the level of information needed to enable new product development and, at the second wave of migration onto service providers' platform, what gaps exist.

We are always cognisant that we retain ultimate responsibility for oversight and the relationship, and keep upgrading risk assessment. It's not just the original deal, it's how the relationship and the industry is evolving.

Our motto 'Keep it simple' also applies to new product development. Outsourcing introduces a discipline to keep enthusiastic fund managers under control as changes can be costly.

In allowing for change, we have an operational chassis with a high performance investment engine, so new products have to work with that chassis. Otherwise you are entirely held to ransom by the outsource provider.

Stage 6: Termination/ Renegotiation

PricewaterhouseCoopers view

It is naïve to assume nothing will go wrong; all contingencies need to be considered with triggers and mechanisms in place for (speedy and amicable!) dispute resolution. Furthermore, it is important to keep these triggers and mechanisms current as the business evolves.

The asset manager needs to be open to re-evaluating the options and be prepared to exercise step-in or exit rights. In doing this, however, it is important to be honest as to how easy it would be to change to insourcing or another provider. Basically, the same disciplines are needed as in the transaction stage. In some ways re-negotiation is easier as it does not involve the people issues of a lift-out; however, the incumbent service provider may have considerably greater bargaining power.

Client view

It is important to get under the skin of an organisation and deal with top management in trying to make the right choice. Deals are difficult to sign but are even more difficult to deliver. There needs to be flexibility for both parties, and both parties need to be making money for it to succeed. It needs to be hard to come out of an outsourcing arrangement, but it does happen, usually when one party has a significant change in business strategy.

Conclusion

Asset managers are increasingly recognising the benefits of focusing on their core competencies, whether they are distribution, product manufacture, or investment performance. As firms examine their underlying cost base, and those of external suppliers for administration services, outsourcing is proving an attractive alternative, as the recent UK explosion in activity demonstrates. Importantly, the change in business models that outsourcing is triggering puts downward pressure on operational costs for all asset managers which brings important competitive implications.

While there are significant challenges in delivering deals and successful outsourcing partnerships, these, in our view, will only increase. In two to three years' time, as the deals become more commoditised, the balance of power, price, and human resource issues are likely to change. Premiums will become rarer; service providers may become more reluctant to do lift-outs (a lower risk strategy for the asset manager, but perhaps not for the service provider). These are all reasons why asset managers may wish to consider outsourcing sooner rather than later.

Client views

We are some way off commoditisation; platforms need more industrialisation and third party administrators need to improve before commoditisation is achieved.

Service providers are continually improving, with feedback from asset managers crucial in achieving that. However, there can be 'indigestion' if a service provider acquires assets and platforms too rapidly.

Outsourcing is a long term partnership which needs substantial management time, effort and money to address, and therefore needs a disciplined approach to make the right choice and make it work. In a time of rapid industry change and consolidation, the issues which created demand for outsourcing: regulation, technology, competition, turbulent markets, cost pressures etc, will continue to impact both partners (even if one is more directly affected). In a relationship which typically lasts 7-10 years, it does not make sense to either cut corners in structuring it, or to adopt a laissez-faire attitude that all will work out for the best; the six stage lifecycle approach ensures that all present and future contingencies are covered.

Outsourcing is not for the faint-hearted!

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