

fs viewpoint

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03

Executive
summary

06

Point of view

16

Competitive
intelligence

21

A framework
for response

29

How PwC
can help

32

Appendix

Making the middle office top of mind:

Transforming the asset management middle office to a bottom-line contributor



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Executive summary

Executive summary

In our view, by failing to effectively transform the middle office into a bottom-line contributor, asset managers are likely to find themselves facing lagging margins and scarce resources at the very time that they are struggling to succeed in an increasingly competitive market.

The result? Significant growth opportunities left on the table.

Going the whole nine yards— a critical success factor.

Most asset managers have implemented simplistic, one-dimensional cost-reduction initiatives aimed to reduce middle-office costs. These actions were driven by increasing middle-office operating complexities, escalating regulatory requirements, and a scarcity of talent.

The problem? Most of these efforts have led to under-investment in middle-office functions, resulting in an infrastructure that is inflexible and unable to scale for increasing product complexity and regulatory requirements.

In our view, by failing to effectively transform the middle office into a bottom-line contributor, asset managers are likely to find themselves facing lagging margins and scarce resources at the very time that they are struggling to succeed in an increasingly competitive market. The result? Significant growth opportunities left on the table.

Conversely, those asset managers that have succeeded in restructuring their operating model have positioned themselves for growth.

Out of the shadows—into the light.

This FS Viewpoint explores the steps that we believe asset managers should take to sustain past improvements and identify future cost and performance opportunities, including up-front questions to ask and objectively answer before moving forward.

Right-sourcing—the name of the game.

We see leading asset managers changing the role of their middle office from that of a transaction processor to that of a strategic business partner through the use of right-sourcing. We define right-sourcing as the process by which an asset manager determines how to most efficiently and effectively provide each middle-office service. Options include insourcing, right-sizing, co-sourcing, or outsourcing (either in full or in part).

Gaining the full benefits of right-sourcing.

Right-sourcing the middle-office functions can help asset managers achieve several benefits, including maintaining or gaining a competitive advantage, and enabling them to leverage scarce resources to focus on strategic decision support and address complex compliance issues.

Executive summary (continued)

With appropriate planning, asset managers can overcome institutional roadblocks to success.

When it comes to right-sourcing, every organization is unique, requiring its own custom-tailored strategy.

With appropriate planning, asset managers can overcome institutional roadblocks to success.

On the following pages, we discuss some of the obstacles that could get in the way of progress, including the presence of strategic alignment gaps, concerns about impacts on employees and culture, and the lack of a clear decision-support and measurement framework, to cite just a few. We also discuss practical ways to overcome these impediments.

When it comes to right-sourcing, every organization is unique, requiring its own custom-tailored strategy.

It is critical that management invest sufficient time and effort up front to evaluate the available options to include in their right-sourcing strategies.

PwC's approach involves assessing the middle office of an organization through three key lenses:

- ① Organizational readiness
- ② Operating model
- ③ Cost and performance

Once assessed, the asset manager can then work to implement and sustain the best-fit model.

The bottom line:

In today's dynamic times, asset managers have a vital decision to make: Do we move forward? Or lag behind?

Those who take steps now to right-source their middle office stand to create a powerful infrastructure that results in a competitive advantage—which, in turn, boosts the bottom line.

Those who sit back and retain the status quo risk being left playing catch-up in an increasingly competitive and turbulent market.

Point of view

Driven by margin and competitive pressures in recent years, many asset managers have scrambled to cut the costs associated with their middle-office functions.

These simplistic cost reductions, however, often missed a significant opportunity: the potential for asset managers to transform the middle office from an administrative go-between to a bottom-line contributor.

Asset managers are now faced with increasing operating complexities and costs, stringent regulatory requirements, and talent constraints. In light of these challenges, asset managers are now realizing that the one-dimensional cost reductions of the past met with only mixed success. In our view, asset managers who defaulted to a simplistic, one-dimensional cost reduction model and failed to transform the middle office will see margins lagging the market.

Drivers behind the need for middle-office transformation include the following:

- Competitive pressures on asset managers are driving expansion into new and more complex asset classes (including alternatives) and geographies. This has led to subscale, fragmented middle-office operations.
- Results from top-down cost elimination efforts have provided a significant one-time benefit, but management is having mixed success in sustaining cost reduction and performance.
- Continued cost-reduction efforts have become extreme; some asset managers are now engaged in fee wars and are dropping custom indexes.
- A regulatory environment with increasingly complex requirements, such as the Fair and Accurate Credit Transactions Act (FACTA) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), has translated into higher compliance costs for middle-office functions.
- Under-investment in middle-office functions has resulted in an infrastructure that is inflexible and unscalable for product, customer, regulatory growth, and increasing product complexity.
- Talent constraints have left asset managers with limited resources. These resources are often focused on transactional tasks instead of strategic support.

Asset managers that made the tough decisions early in the crisis to restructure their operating model (such as reducing costs by up to a third from 2007 to 2009 and cutting back on or exiting lower-margin businesses) were in the best position to make selective investments for growth in 2010.

While their costs relative to assets increased slightly by 0.3 bps in 2010, pre-tax operating margins for this group grew to 33 percent.¹

¹ McKinsey & Company, "Growth in a Time of Uncertainty the Asset Management Industry in 2015," November 2011, mckinsey.com, accessed November 14, 2013.

We have observed many asset managers now focusing on opportunities for effectiveness gains in the middle office.

The growth in the middle-office outsourcing market has resulted from the increased breadth, depth, and capabilities of the services offered by middle-office technology and service providers. This is true of both traditional and alternative asset servicers.

The middle office serves as a go-between for front office trading and back office administration. Each asset manager has unique middle-office risks and requirements. We provide our view of the middle office and some key service features in the table to the right.

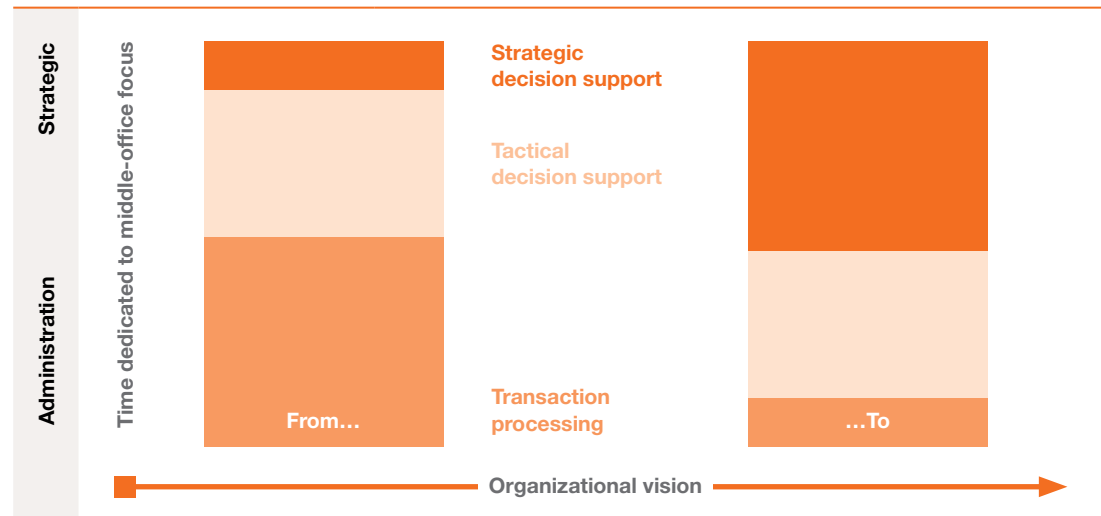
In our experience, those asset managers who have either held the line or increased margins have accomplished gains largely through a combination of cost-control measures and front-office product innovation.

The middle office has direct linkages to the trading rooms and therefore revenue generation. As a result, we have observed that successful outsourcing efforts are often accompanied by a strong internal organization that is able to bridge the gap between service providers and trading desks.

The use of outsourcing by asset managers increases as they achieve the business scale and/or product complexity necessary to benefit from an outsourced relationship. As asset values have rebounded post crisis and product enhancement has resumed, the use of outsourcing has accelerated. In addition, a portion of this growth can be attributed to the evolution of the middle-office outsourcing market, through the increased breadth, depth, and capabilities of the services offered by middle-office technology and service providers. In our view, asset managers who have focused solely on cost reductions may continue to lag industry leaders with respect to their sustainable margins.



*We have observed leading asset managers going beyond one-dimensional, cost-reduction initiatives. They are changing the role of the middle office from a transaction processor to a strategic business partner through the use of right-sourcing.**



***Right-sourcing**—We define right-sourcing as the process by which an asset manager determines how to most efficiently and effectively provide each middle-office service. Options include insourcing, right-sizing, co-sourcing, or outsourcing (either in full or in part).

Right-sourcing

| Insourcing | Right-sizing | Co-sourcing | Outsourcing |
|---|--|--|---|
| Bringing certain outsourced functions back in house as transformed or improved functions. | Restructuring the internal middle-office functions, potentially including process efficiencies and service enhancements. | Supplementing internal middle-office functions with flex resources to realize efficiencies and increase effectiveness. | Contracting middle-office functions to an external provider, increasing efficiency and effectiveness. |

| | "As-is" | "Mid-way" | "To-be" |
|-----------|--|---|--|
| Behaviors | <ul style="list-style-type: none"> Middle-office services exist in silos. Transactional processing requires excessive manual effort and attention. | <ul style="list-style-type: none"> Middle office collaborates with the front office. Contains some capacity for analysis. Has higher degree of automation and better control. | <ul style="list-style-type: none"> Middle office viewed as a strategic business partner. Operational performance managed through the use of metrics. Has proactive decision support. Relies less on static data, more on accessibility of actionable information. System integration capacity increases. Middle-office operations are low cost and highly automated. |
| Examples | <ul style="list-style-type: none"> Focus is on ad hoc solutions and workarounds. Typical focus is on simplistic cost-reduction levers such as headcount. | <ul style="list-style-type: none"> Understanding of the staff-driven cost profile such as staff productivity metrics. Understanding of fixed/variable cost composition. Understanding of process capacity. | <ul style="list-style-type: none"> Sophisticated understanding of costs and process efficiency such as activity-based costing. Workforce management beyond headcount reduction focused on reduction of transaction costs (for example, via automation and demand-responsive, variable cost staffing models) and enhancement of strategic operational management skills and capabilities. |

In our view, the middle office should no longer be hidden in the shadows, simply serving as a link between the front and back offices.

Right-sourcing the middle office can deliver value beyond one-dimensional cost reductions. It can position the middle office in a new role as a significant contributor to the bottom line.

To transform the middle office from a transactional-based processor to a bottom-line contributor, asset managers should:

- Strategically target the “first set” or “next set” of middle-office functions that can be right-sourced.
- Create sourcing strategies for the middle office that address a broader range of qualitative and institutional factors than the more straightforward, back-office processes, including:
 - Organizational readiness and the degree of right-sourcing already undertaken.
 - The operating model, including the range and complexity of products in scope.
 - The degree of cost and performance management discipline and maturity already in place across the organization.
- Embed a cost- and performance-management discipline—building a consistent, repeatable, and transparent process for evaluating cost and performance of services.

This will help asset managers sustain past improvements and identify future cost and performance opportunities.

As a first step to achieving right-sourcing, asset managers should objectively answer the following questions.

| Theme | Questions |
|-------------------------------------|--|
| Understanding cost and performance | <ul style="list-style-type: none"> • How can I maintain a competitive cost structure given increased product, regulatory, and client expectations? • Do I understand our cost structure, including the fixed vs. variable and discretionary vs. non-discretionary components, and the extent to which we are competitive with industry peers? • Do I have insight into the cost and performance of my operations, technology, and other support functions? • Is my middle office a business partner contributing to net income through active involvement in the following? <ul style="list-style-type: none"> – Retaining customers by enhancing customer service. – Understanding customer profitability. – Cross-selling. – Identifying new products and bringing them to market. • Do I know how my middle-office service levels benchmark to my competitors or fee-for-service providers? |
| Business profitability implications | <ul style="list-style-type: none"> • What are my most/least profitable businesses, products, functions, or customer segments? • Do I use cost-model information to make better business decisions regarding pricing, product mix, sourcing, and functional extension of sourcing relationships and segment strategy? |
| Sourcing implications | <ul style="list-style-type: none"> • Given my organization and products, is there an opportunity to pursue a sourcing strategy? • Am I in a position to leverage cost-modeling information to evaluate the benefits of sourcing and provide insight into benchmarking of sourcing services? |

Right-sourcing the middle-office functions can help asset managers achieve several benefits, including maintaining or gaining a competitive advantage, and enabling them to leverage scarce resources to focus on strategic decision support and address complex compliance issues.

| | Right-sourcing | | | |
|------------------------------|---|--|--|--|
| | Insourcing | Right-sizing | Co-sourcing | Outsourcing |
| Definition | Bringing certain outsourced functions back in-house as transformed or improved. | Restructuring the internal middle-office functions, including process efficiencies and service enhancements. | Supplementing internal middle-office functions with flex resources to realize efficiencies and increase effectiveness. | Contracting middle-office functions to an external provider, increasing efficiencies and effectiveness. |
| Benefits | | | | |
| Innovation and growth | Flexibility to customize solutions, such as customized processes for voluntary corporate actions with portfolio managers. | Automated workflow management across multiple aspects of the asset management value chain, such as front-, middle-, and back-office integration. | Particular vendors may have specific strengths in workforce and workflow management. | As basic operational functions become table stakes, service providers are increasingly differentiating themselves by offering advanced analytics and reporting. Examples are performance attribution, custom benchmark maintenance, transaction scenario analysis, portfolio-level risk analysis, and hedging. |
| Operational risk | Control over the mitigation processes and level of effort associated with operational risk. | Adoption of industry leading practices increases the effectiveness and efficiency of controls. | Ability to shift part of the operational risk liability to the co-sourcer or have financial recompense (specifically negotiated contract items). | Shifting full operational risk to the service provider, such as errors in corporate actions. |
| Operating costs | Scale players bringing functions back in house eliminate service provider spread. | Reduced operating costs due to fewer resources used to deliver same or enhanced level of service. | Ability to staff up or down based on the business cycle with greater facility; however, must pay staffing partner spread. | Total cost reductions based on efficiency gains, such as moving from a manual process to straight-through processing. In addition, cost variability and tiered rate cards can be negotiated to provide known operational benefit. |

Any large-scale initiative will encounter obstacles. With appropriate planning, asset managers can overcome these roadblocks and begin seeing the benefits of a transformed middle office.

| Obstacle | How to address |
|--|--|
| <p>Presence of strategic alignment gaps:</p> <ul style="list-style-type: none"> • Lack of vision for target operating model. • Reduced service quality due to strategic misalignment of previous cost-cutting efforts. • Concerns that clients may under-value the asset manager's middle-office services. | <p>Define goals for sourcing strategies that take into consideration:</p> <ul style="list-style-type: none"> • Assessment of impact of middle-office sourcing in all of the firm's overall goals. • Understanding what is differentiating about the asset manager's product offerings. Where do these offerings compete and how do they add value to clients? • Sourcing strategy that measures and tracks all outcomes, including all dimensions of client service quality and profit and loss impacts. |
| <ul style="list-style-type: none"> • Lack of a clear understanding of changing regulatory landscape. | <ul style="list-style-type: none"> • Understand and communicate the impact of change in regulatory landscape on business segments and on how business segments fulfill client needs. |
| <p>Concern about impacts on employees and culture, including:</p> <ul style="list-style-type: none"> • Worry about losing critical knowledge/expertise. • Fear of increased turnover across the firm caused by layoffs in operations. • Personal conflicts that compromise the integrity of analysis. • Anxiety over the loss of control of front-office-adjacent functions. | <ul style="list-style-type: none"> • Consider possibility of key staff being offered positions at the service provider. Gained expertise for new product introductions and market entry often more than compensates for change impacts. • Communicate changes and reassure impacted staff. • Use a third party to challenge analysis and assumptions. • Use service-level agreements (SLAs) internally and externally to address control and responsiveness issues. • Loss of control over front-office-adjacent functions is largely addressed through service providers' recent focus on workflow transparency and service-level standards. |
| <p>Lack of a clear decision support and measurement framework that:</p> <ul style="list-style-type: none"> • Articulates the case for change for middle- and back-office outsourcing. • Defines and maps middle- and back-office services and their cost drivers to business segments. | <ul style="list-style-type: none"> • Establish a decision support framework that clearly defines product services, drivers of revenue/costs, and key performance indicators (KPIs). • Apply benchmarking to peer organizations and undertake a thorough cost analysis that identifies the fixed/variable structures and cost drivers. • Define the middle- and back-office services, activities, and tasks provided to business units. • Provide cost-benefit analysis comparison of providing services internally vs. externally (outsourced) and relative pros and cons. Use a third party to challenge analysis and assumptions. |
| <p>Concerns that a third-party processor either cannot supply all of the services currently performed by in-house staff and/or that the quality of those services will be inferior to that of in-house staff.</p> | <ul style="list-style-type: none"> • The middle-office services market has matured substantially over the past decade. This is characterized by the current breadth and depth of service offerings, greater standardization of service levels, and improved price transparency. • Misperceptions about third-party processors' offerings can be allayed by sourcing analysis. Often the independence of a third-party back office provides comfort to sophisticated investors. • Data privacy concerns should be addressed. |

**One size does not fit all.
Management should
evaluate options for right-
sourcing strategies.**

Our approach involves assessing the organization through the following three lenses: organizational readiness, operating model, and cost and performance. Once assessed, the asset manager then determines the best fit and works to implement and sustain the best-fit model.

1 Apply organizational readiness lens



Is the organization capable of supporting alternate sourcing or can the middle office improve to meet the front office demands?



Understanding of your capabilities across four dimensions:

- Organization.
- People.
- Technology.
- Process.

2 Apply operating model lens

How do my products and front-office needs influence my middle office?

Understanding of:

- Front-office product and service requirements.
- Capacity redundancies.
- Business model growth needs.
- Resource constraints.

3 Apply cost and performance lens

How does my middle office perform (cost and performance) in relation to front-office needs and industry norms?

Full understanding of the impact of the office to the business and the bottom line.

4 Determine best fit



What is the right mix of staffing and systems competencies, cost, performance, and risk for my organization?



Selection of insourcing, right-sizing, co-sourcing, or outsourcing.

5 Transform

How do we execute the program with minimal impact to customers and business?

- Improved operating model.
- Middle office is a bottom-line contributor.

6 Sustain

Do we continue to achieve the benefits we expected?

- Middle office provides the services and functions necessary to compete.
- Key performance indicators are available for ongoing evaluation.



Asset managers have an important decision to make:

Those who move forward to right-source the middle office can create a powerful infrastructure that contributes to a competitive advantage.

Those who retain the status quo could be left playing catch-up in an increasingly competitive and turbulent market.

Failure to act now will have asset managers dealing with critical issues such as:

Innovation and growth

- Increased liquidity reserves due to inaccurate and imprecise liquidity stress test calculations, which dilutes fund performance.
- Higher costs and longer time-to-market than competitors for new and emerging products leads to loss of competitive advantage.
- Lack of management insight into the amount of capital, funding, and liquidity required to invest in new businesses and generate new sources of revenue leads to missed opportunities. For example, an asset manager may not be able to shift capital/funding/liquidity to seasonal products that require capital, funding, and liquidity during periodic peaks.
- Reduced ability to issue structured notes, which could result in higher funding costs due to activities and lifecycle events being performed improperly.

Profits

- Lack of insight into cash usage leads to lost opportunities to reduce liquidity reserves and associated interest expense.
- Inability to provide best-of-breed customer service results in reduced customer retention, decreased assets under management (AUM), and lower profits.
- Exhaustion of cost take-out opportunities leads to a race to the bottom on fees to maintain customers, AUM, and profits.

Operational risk

- Inability to accurately calculate interest-rate-basis risk and foreign-exchange-basis risk decreases confidence in hedging strategies.
- An inability to quickly and accurately respond to regulators' inquiries and expectations leads to increased oversight by regulatory bodies.
- Inefficient and ineffective systems and processes result in a decreased ability to comply with new regulations.

Operating costs and performance






- Continued reliance on applications/processes that require significant manual inputs and reconciliations increases costs and decreases efficiency.
 - End-to-end processes continue to lag competitors in terms of completeness, accuracy, and timeliness, impacting management's ability to make good, timely decisions.
 - Cost structures remain fixed and cannot react rapidly to market conditions, leading to loss of competitive advantage.
-

Competitive intelligence






*Our observations of
industry practices.*

Most of the top asset managers have recently transformed their middle offices or are currently undergoing transformations. Large-to-small asset managers need to follow suit to maintain market share and meet shareholder expectations for profitability.




|  <p>Change drivers and risks (Why was it considered and what are the risks?)</p> |  <p>Organizational readiness (Is the organization capable of supporting alternate sourcing?)</p> |  <p>Operating model (How do my products and front-office needs influence my middle office?)</p> |  <p>Cost and performance (What are the financial implications of decision?)</p> |  <p>Results (How were decisions implemented and what were the overall results?)</p> |
|---|---|---|---|--|
| <ul style="list-style-type: none"> • Sustainable cost reduction. • Reducing organizational complexity. • Improving operational service levels. • Improving client service levels. • Providing scalability for growth. • Adding to functional capabilities. • Avoiding infrastructure and other capital expenditures. | <ul style="list-style-type: none"> • Achieving stability and control over the functions to be outsourced. • Modeling the retained organization. • Modeling prospective commercial terms. • Project structuring and resourcing. • Organizational backing and support. • Understanding of key performance indicators (KPIs) to measure success. | <ul style="list-style-type: none"> • Trading and investment strategies. • Investment vehicles. • Global footprint. • Centers of excellence/ centralized services. | <ul style="list-style-type: none"> • Identify middle-office services. • Baseline costs. • Impacted people. • Technology/infrastructure. • Facilities. • Activity-cost modeling. | <ul style="list-style-type: none"> • Transformation methodology and complexity. • Multi-functional team structure. • Fully-ranked key selection criteria. • Utilization of vendor site visits. • Utilization of vendor evaluation scripts. • Separation of commercial terms from operational discussions. • Implementation methodology. • Provider and client utilization of common roadmap. • Adequate resourcing. • End-client management. • Measurability of success through KPIs, cost, and profitability management framework. |

For asset managers who have begun the middle-office transformation, the change drivers have varied, from cost reductions to an inability to keep up with technology, and even to a gap in middle-office performance.

| Our observations of market practice | | | |
|-------------------------------------|--|---|---|
| | Asset manager A | Asset manager B | Asset manager C |
| Change drivers and risks | <ul style="list-style-type: none"> • Lagging cost-income ratio. • Core processing platform to be sunset in future, and in-house maintenance is unsustainable. • Middle-office functions challenged to innovate in lock step with front office due to inflexible technology and budget constraints. • Concern about required investment to enhance technology platform. | <ul style="list-style-type: none"> • Core platform did not support all functionalities such as multicurrency capabilities on certain products for future product expansion. • IT, operations, and platform costs were high and markets were adversely impacting the revenue opportunities in asset classes. • Motivation to focus on middle-office capabilities related to complex, specialized asset classes and to leverage vendor capabilities for standard asset classes. • Cost transparency infrastructure did not exist and needed to be created. This included project accounting framework for IT programs and activity-based cost management methodology. | <ul style="list-style-type: none"> • Urgent need to meet expense reduction targets provided to the investment community. • Concern about required investment to enhance technology platform. • Desire to improve service levels to a decentralized structure by allowing local design and control of middle-office services (within provider's parameters). • Reduced time to market for new products and expansion into new areas. |
| |  Risks <ul style="list-style-type: none"> • Enterprise buy-in by top executives. • Client expectations and communications. • Counterparty/headline risk. • Human capital risks due to organizational changes. |  Risks <ul style="list-style-type: none"> • Vendor's capability on complex asset classes. • Vendor process and timeline synchronization issues. • Cost take-out and avoidance goals were evolving. |  Risks <ul style="list-style-type: none"> • Too many moving parts due to simultaneous order management system upgrade. • Need to compromise, prioritize requirements, and phase "must haves" to shorten implementation. • Political dynamics of selecting one provider to service multiple, independent lines of businesses. |




Each firm had unique situations, which contributed to differing success factors and challenges. The following table outlines our observations for three asset managers.

| | Asset manager A | Asset manager B | Asset manager C |
|---------------------------------|---|--|---|
| Organizational readiness | <ul style="list-style-type: none"> High service levels maintained with trading clients. Target end state not achievable due to restricted budgets. Lack of top executive support. Legacy technology is not flexible and requires significant ongoing maintenance. | <ul style="list-style-type: none"> Management was proactive to right-size and outsource functions to align operations better with overall business objectives. Strong business unit leadership buy-in to drive performance transparency. | <ul style="list-style-type: none"> Strong commitment from top executives and support of shareholders. Firm had outsourced several services and functions. |
| Operating model | <ul style="list-style-type: none"> Single technology operating platform allowed for commonalities across regions. Some utility services centralized to global operations centers. Differing regulatory requirements and customer privacy considerations. | <ul style="list-style-type: none"> Firm identified capability, scale, and complexity as factors to evaluate middle-office functions by investment strategies and/or products in order to focus outsourcing efforts. | <ul style="list-style-type: none"> Operations and technology were mature and organized as shared services. Outsourcing provided a menu of options of middle-office services to be leveraged by decentralized front offices. Investment manager usage of derivatives was constrained by limited middle-office accounting and risk capabilities. |

 Leading
  On par
  Lagging

Each firm had unique situations, which contributed to differing success factors and challenges. The following table outlines our observations for three asset managers (continued).

| | Asset manager A | Asset manager B | Asset manager C |
|-----------------------------------|--|---|--|
| Cost and performance | <ul style="list-style-type: none"> High transparency of costs across middle-office functions. Middle-office operations and technology groups running at capacity across global centers of excellence. Relatively high cost-to-income ratio compared to peers. | <ul style="list-style-type: none"> The firm did not have full transparency of data on operational and technology costs. Comparisons of outsourcing future benefits were not fully developed. | <ul style="list-style-type: none"> Performance was stable with attributable cost data. KPIs were immature and underdeveloped. Middle-office operations performance was based on satisfaction levels associated with lines of business. |
| Implementation and results | <ul style="list-style-type: none"> Detailed planning and working sessions between manager and service provider. Failed to obtain deal approval from top management due to regulatory and client risks. | <ul style="list-style-type: none"> Firm right-sized and kept in-house the complex asset classes and outsourced the operations and asset classes that offered efficiencies. Aligned and reorganized IT and operations functions to better support profit and loss business lines effectively. Scaled key-asset class areas to leverage external growth opportunities and to reduce reliance on captive-asset base. Management targeted a cost reduction of 20% over five years on the overall operations and IT cost base. Now on target with firm achieving 6% cost take out and cost avoidance during first two years. | <ul style="list-style-type: none"> Structured methodology, led by core project management office comprised of the firm and vendor operations and technology. Steering committee for each line of business as well as overall program. Utilized test scripts and conducted true end-to-end testing. Lack of KPIs to measure success. The focus is on meeting requirements and timeline. |

 Leading
  On par
  Lagging

A framework for response

A large orange rectangular box containing the text "Our recommended approach to the issue." Below the box, there is a small orange square.

*Our recommended approach
to the issue.*

Our approach to right-sourcing the middle office involves assessing the organization through the following three lenses: organizational readiness, operating model, and cost and performance.

Once assessed, the asset manager then determines the best fit and works to implement and sustain the best-fit model.

1 Apply organizational readiness lens



Is the organization capable of supporting alternate sourcing or can the middle office improve to meet the front office demands?



Understanding of your capabilities across four dimensions:

- Organization.
- People.
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- Process.

2 Apply an operating model lens

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Understanding of:

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How does my middle office perform (cost and performance) in relation to front-office needs and industry norms?

Full understanding of the impact of the office to the business and the bottom line.

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What is the right mix of staffing and systems competencies, cost, performance, and risk for my organization?



Selection of insourcing, co-sourcing, or outsourcing.

5 Transform

How do we execute the program with minimal impact to customers and business?

- Improved operating model.
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6 Sustain

Do we continue to achieve the benefits we expected?

- Middle office provides the services and functions necessary to compete.
- Key performance indicators (KPIs) available for ongoing evaluation.



Step 1:

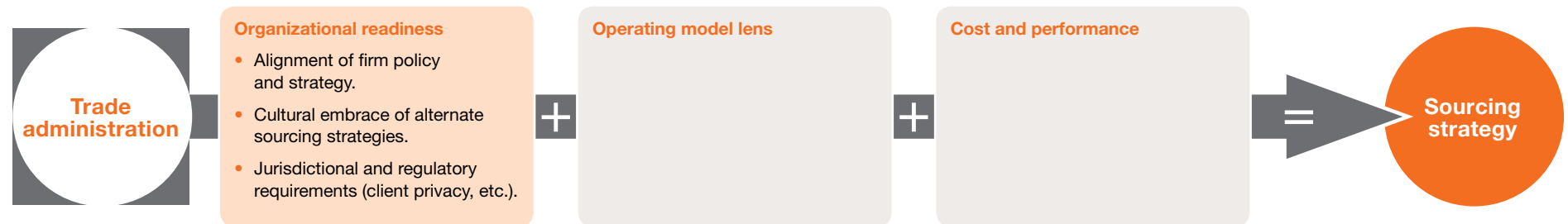
Apply organizational readiness lens

Asset managers should take a critical look across four key dimensions and ask, “Are we prepared to make a sustainable change to our business model?”

To answer this question, asset managers need to have at least a high-level understanding of the following four dimensions: organization, people, technology, and process.



Example: Trade administration



Organizational readiness questionnaire

| Question | Score: | Low | | | High |
|--|--------|-----|---|---|------|
| Organization | | | | | |
| What are our opportunities and risks? | | | | | ● |
| What is our time horizon to realize benefits? | | ● | | | |
| Can a target end state be achieved internally? | | ● | | | |
| Do customer contracts restrict sourcing? | | | ● | | |
| People | | | | | |
| Do we have the right talent? | | | | ● | |
| Can we create a service-oriented culture? | | | | ● | |
| Which locations have access to skilled resources? | | | ● | | |
| What are our language requirements? | | | | ● | |
| Technology | | | | | |
| Can we keep up with the rapid technological changes required by evolving regulatory requirements? | | ● | | | |
| Does our current technology provide the information required for multi-faceted profitability analysis? | ● | | | | |
| Process | | | | | |
| To what degree do we want to control processes? | | | | ● | |
| Can we maintain cost and performance measurement to ensure process efficiencies into the future? | | | ● | | |
| Can we manage service levels internally? | | | | ● | |

Step ②:

Apply an operating model lens

Products utilized by different types of asset managers—whether they are traditional or alternative managers—drive middle-office processing requirements and influence the cost profiles.

An understanding of these relationships is necessary as a general scoping consideration for cost reduction.

An assessment of product and service relationships and requirements is necessary before transforming the middle office. Asset managers will need to:

- Define the middle-office service catalog and confirm availability of supporting data.
- Understand linkages among services and activities to current and future products and services.
- Gauge capabilities relative to current and future strategies.
- Define existing interdependencies that could disrupt the business post-transformation.

Once asset managers understand the products and service requirements, they should better understand:

- How easily middle-office services can be disaggregated to take advantage of transaction processing, specialty services, and decision-support sourcing efficiencies.
- Current and potential staff overlap and redundancies resulting from multiple geographies and/or business units with independent support organizations or plans to grow through acquisitions, joint ventures, or alliances.
- Staffing inefficiencies resulting from subscale operations characterized by a high management-to-staff ratio or a high proportion of employees in high-cost geographies.

Example: Trade administration

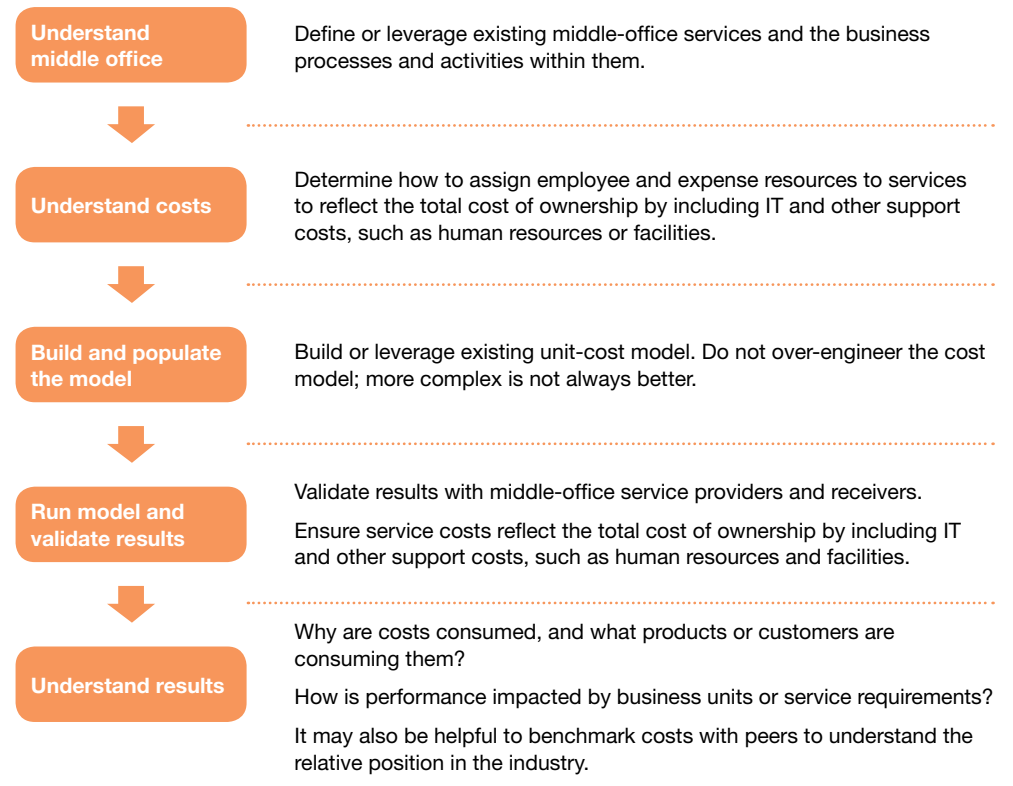


Step ③:

Apply cost and performance lens

An assessment of the cost and performance of the middle-office functions should be unbiased, allowing for a true picture of the way in which the middle office contributes to the bottom line.

Models do not need to be too complicated. If the existing cost model is leveraged, asset managers should help ensure that the performance assumptions factored into the model are properly calibrated to their desired service level.



Example: Trade administration



Step 4:

Determine best fit

In its simplest terms, determining best fit is identifying the right staffing and systems competencies, cost, and risk for required services.

Through the assessment of each function across the defined lenses, an organization can determine the best-fit solution. To the right is an illustrative example of how an organization may view itself through the lenses.

In this example, while the results of reviewing both the operating model and cost and performance lenses pointed to *outsourcing*, the low level of organizational readiness dominated the analysis, indicating a low capability to supporting alternate sourcing. In this example, the end result was *insourcing/right-sizing*.

| Lens | Insourcing/right-sizing | Co-sourcing | Outsourcing |
|--------------------------|---|---|--|
| Organizational readiness | In-house processing is valued by clients; high degree of systems integration with front office; key operations talent must be retained. | Asset manager can implement a model that retains key operations in-house while leveraging a third-party scale for less critical/visible operations. | Clients are comfortable with outsourcing; technology platform is open and easily disaggregated; operations staff is not critical to the future performance of the asset manager. |
| | ← Negative | Readiness | Positive → |
| Operating model lens | Operating model is focused in a limited set of asset classes and geographies. | Operating model includes a mix of efficient, sustainable functions and higher cost and/or poorly performing groups. | High level of complexity; multiple jurisdictions with small footprint in each. |
| | ← Low | Complexity | High → |
| Cost and performance | Current costs compare favorably to benchmarks; technology is up to date. | Costs are middle of the pack; operational strategy (staffing, locations, etc.) is effective but technology is outdated. | Unit costs are unfavorable; technology is outdated; operations are fragmented and subscale. |
| | High | Efficiency and effectiveness | Low → |

Example: Trade administration



Step 5: Transform

Develop activities that are tailored to the sourcing strategy, reflecting common precursors and achievements.

Precursors...

- Senior executives mobilized to drive the implementation.
- Full alignment of asset manager business requirements and commercial arrangements.
- Governance model that fits complexity (number of parties, services, funds, geographies involved).
- End-state success criteria defined.
- Detailed transition plan including design, development, testing, migration, and closure phases.
- Communications plan tailored to informational needs of all stakeholders.

Activities tailored to meet sourcing option selected.

Achievements...

- The new operating model is in place and functioning as designed for all parties.
- Staff trained and incentives provided to work in the new way.
- Staff adopted the new working processes.
- New standards, practices, and procedures are documented and available.
- Ways for assessing and monitoring ongoing operating model effectiveness are in place.
- All impacted third parties (for example, clients, custodians) have adapted to the new processes.

| | Insourcing/right-sizing | Co-sourcing | Outsourcing |
|-------------------------------|--|--|-------------|
| Assess | <ul style="list-style-type: none">Assess and align internal resources to drive the initiative including small and medium enterprises to vet operating model design considerations. | | |
| Design | <ul style="list-style-type: none">Develop detailed business case.Develop 'to-be' operating model that includes people, processes, and technology. | | |
| Construct | <ul style="list-style-type: none">Build and test operating model changes needed to deliver benefits.Establish clear implementation dates and milestones.Build cost and performance tools to periodically measure performance to service level agreements (SLAs). | | |
| Additional construct criteria | <ul style="list-style-type: none">Develop future-state processes and service delivery model geared toward increased efficiencies.Develop appropriate SLAs and cost and performance measurement tools. | <ul style="list-style-type: none">Perform vendor selection based on operating model criteria and vendor capabilities.Conduct contract negotiations, develop SLAs, and establish ongoing working relationship. | |
| Implement | <ul style="list-style-type: none">Implement changes and validate operations. | | |

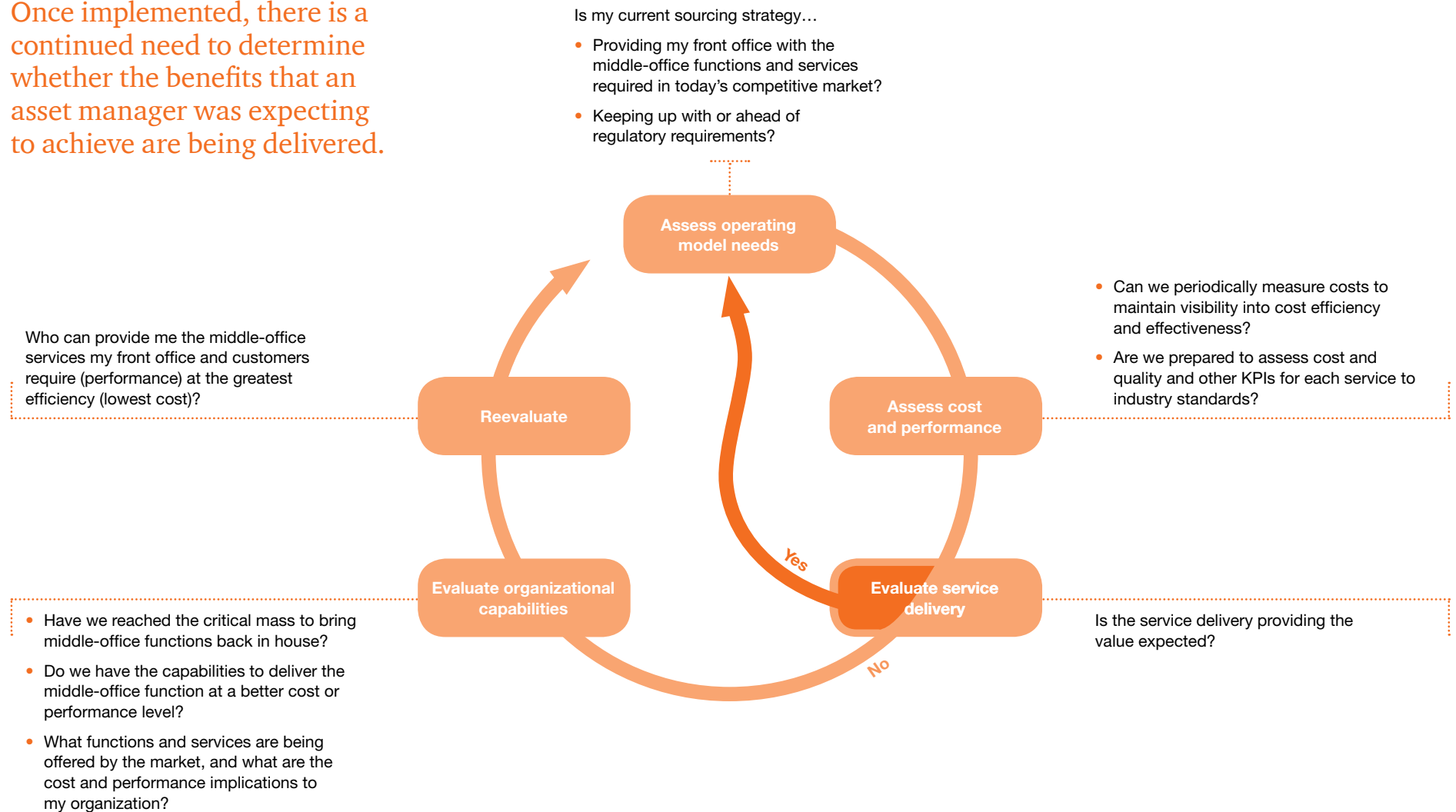
Checklist

- ☒ Are the asset manager's business/operational needs fully documented and prioritized?
- ☒ Do all internal and external parties understand roles in the new operating model?
- ☒ Does our testing plan address all key requirements, operating risks, and controls?
- ☒ Do we need to modify the solution to make it work?
- ☒ Do we have a migration playbook ensuring proper control in moving to the new solution?
- ☒ Is it working as planned—operationally and commercially?

Step 6:

Sustain

Once implemented, there is a continued need to determine whether the benefits that an asset manager was expecting to achieve are being delivered.



How PwC can help



*Our capabilities and
tailored approach.*

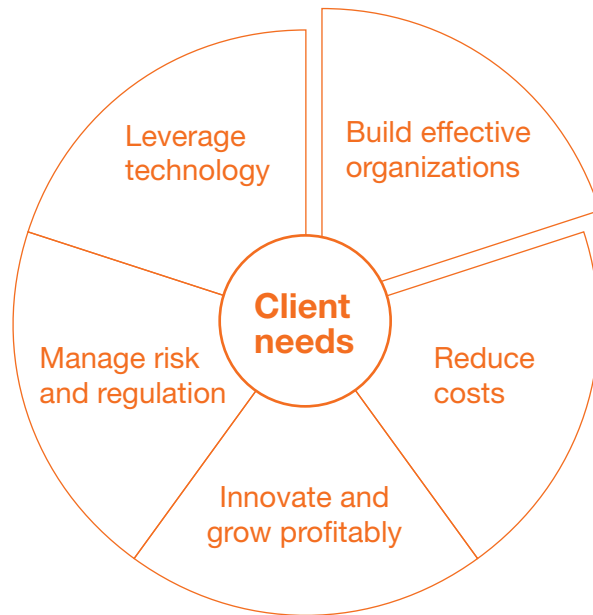


What makes PwC's Financial Services practice distinctive.

| | |
|---|--|
| Integrated global network | With 34,000 industry-dedicated professionals worldwide, PwC has a network that enables the assembly of both cross-border and regional teams. PwC's large, integrated global network of industry-dedicated resources means that PwC deploys the right personnel with the right background on our clients' behalf whenever and wherever they need it. |
| Extensive industry experience | PwC serves multinational financial institutions across banking and capital markets, insurance, asset management, hedge funds, private equity, payments, and financial technology. As a result, PwC has the extensive experience needed to advise on the portfolio of business issues that affect the industry, and we apply that knowledge to our clients' individual circumstances. |
| Multidisciplinary problem solving | The critical issues financial institutions face today affect their entire businesses. Addressing these complexities requires both breadth and depth of experience, and PwC service teams include specialists in strategy, risk management, finance, regulation, operations, and technology. This allows us to provide support to corporate executives as well as key line and staff management. We help address business issues from client impact to product design, from go-to-market strategy to an optimized economic model, to proper functional practices across all aspects of the organization. We excel at solving problems that span the range of our clients' key issues and opportunities, working with the heads of the business, risk, finance, operations, and technology operations. |
| Practical insight into critical issues | In addition to working directly with clients, our practice professionals and Financial Services Institute (FSI) regularly produce client surveys, white papers, and points of view on the critical issues that face the industry. These publications—as well as the events we stage—provide clients new intelligence, perspective, and analysis on the trends that affect them. |
| Focus on relationships | PwC firms provide industry-focused assurance, tax, and advisory services to enhance value for our clients. More than 184,000 people in 157 countries in firms across the PwC network share their thinking, experience, and solutions to develop fresh perspectives and practical advice. |

PwC Advisory

We look across the entire organization—focusing on strategy, structure, people, processes, and technology—to help our clients improve business processes, transform organizations, and implement technologies needed to run their businesses.



| Client needs | Issues we help clients address |
|-------------------------------|--|
| Build effective organizations | <ul style="list-style-type: none"> Establish effective strategic sourcing and procurement strategies and metrics. Realize competitive advantage through effective back- and middle-office operations. Transform business information to drive insight and fact-based decisions. Transform the close and consolidation process, focusing on business analytics over reporting. |
| Reduce costs | <ul style="list-style-type: none"> Drive efficiency through shared services or outsourcing. Reduce fixed costs, making the business more agile to market conditions. Take control of cost, linking cost consumption to the use of those cost. |
| Innovate and grow profitably | <ul style="list-style-type: none"> Align costs to products and customers for better profitability analysis. Reshape the back and middle offices into sources of innovation. Evaluate outsourcing and insourcing strategies to position for the future. Realize deal synergy and value in back- and middle-office consolidations. Developing sustainability programs that add value. |
| Manage risk and regulation | <ul style="list-style-type: none"> Build a risk-resilient organization. Streamline regulatory and compliance reporting. Automate manual processes to reduce errors and improve controls. Safeguard business and client data. Assess the control environment and mitigate risk in your global business operations. |
| Leverage technology | <ul style="list-style-type: none"> Reduce or eliminate proprietary system dependencies. Implement an integrated global technology capability. Improve controls and continuity of operations. |

Appendix

Select qualifications.

Cost structure evaluation and right- sourcing assessment— Global asset manager

Issues

After years of implementing point solutions for their technology and operations platforms, our client, a global asset manager, had an industry-lagging, cost-to-income ratio and could not keep up with the constantly evolving requirements of the front office. The client asked PwC to help evaluate its options for improving cost structures. Options included outsourcing all or part of its middle-office operations or implementing a best-in-class technology solution.

Approach

PwC assisted the client in the following ways:

- Helped the client develop a methodology to determine base-line current cost structures across operations and IT.
- Helped the client develop cost models to estimate future costs associated with a variety of potential solution options.
- Helped the client uncover insights into whether outsourcing met the firm's strategic objectives and were aligned with the firm's culture by providing a holistic evaluation approach to the right-sourcing question.

Benefits

The client was able to make a balanced, fact-based decision on outsourcing that addressed strategic, financial, and cultural concerns.

Middle-office transformation and vendor risk and compliance assessment—Leading institutional asset management firm

| | |
|----------|--|
| Issues | <p>Our client wanted to implement strategic sourcing to reduce costs and improve scale and functionality of its middle- and back-office service efficiency. In order to achieve these goals, the client wanted to:</p> <ul style="list-style-type: none">• Convert from a fixed-cost to a variable-cost model for certain middle-office services.• Support the firm’s expansion strategy by shortening the time needed for onboarding of new products and advisors. <p>In addition, the client’s executive management required: 1) a better understanding of the costs associated with providing the services; 2) the ability to equitably allocate full costs to profit centers; and 3) clear descriptions of cost drivers to improve user accountability for service usage.</p> |
| Approach | <p>PwC assisted the client in the following ways:</p> <ul style="list-style-type: none">• Helped the client manage the transformation process of outsourcing key middle-office services to a third-party provider.• Helped the client assess and provide recommendations for vendor accountabilities to mitigate risks and compliance issues.• Helped develop a cost-allocation model and a driver-based framework for shared expenses allocation that enables effective business-unit performance measurement in the long run.• Performed an assessment of cost-management tools and provided recommendations to automate analysis and report production. |
| Benefits | <p>The client achieved a cost reduction of more than US\$10 million over five years through cost avoidance in the operations and IT areas. In addition, the client achieved a scalable infrastructure and was able to leverage economies of scale to support new product launches and geographic expansion. The client also improved management of operational risk in corporate actions.</p> |

Legacy in-house capability assessment and third-party evaluation— Multi-asset class manager

Issues

Our client, a diversified, alternative asset manager, had previously outsourced many middle- and back-office functions for custody, administration, accounting, and reporting. However, due to a significant change in its investment portfolio over time, the client had maintained significant in-house capabilities and technology to support all of its needs. The client was looking for an integrated solution that would allow it to retire certain in-house technologies and reduce the amount of full-time equivalents dedicated to performing these functions.

Approach

PwC assisted the client in the following ways:

- Worked with the client to identify the scope of services, development of requirements, and identification of a short list of service providers to include in the evaluation.
- Provided assistance with the evaluation of service provider responses and demonstrations.
- Developed a detailed financial analysis model by collecting and analyzing financial details and cost information from service providers.
- Prepared an assessment incorporating observations on the service providers' abilities to meet the client's functional requirements, as well as the organizational fit between providers and the client. This assessment was presented to the client's investment committee.

Benefits

Based on the established evaluation criteria, the client was able to make an unbiased decision on which service provider to select. The client also obtained approval from its investment committee to move forward with vendor selection.

*Vendor analysis—
Large private equity firm*

| | |
|----------|--|
| Issues | A large, committed, capital private equity firm spun off from a corporate parent. As a result, the private equity firm lost its scale pricing agreement with an outsourced service provider. |
| Approach | <p>PwC assisted the client in the following ways:</p> <ul style="list-style-type: none">• Helped the client assess the financial aspects of several competing middle- and back-office service provider bids.• Helped develop a custom pricing comparison model that evaluated the proposals throughout the investment lifecycle (fund investment, wind down, and divestiture schedules), across multiple market and performance scenarios.• Assisted the client by conducting confidential reference checks and obtaining objective opinions of service providers. |
| Benefits | <p>As a result of this work, the private equity firm achieved the following benefits:</p> <ul style="list-style-type: none">• The PwC commercial terms modeling tool helped the client to make an informed decision using normalized data and future growth objectives.• Our confidential reference checks provided the client with objective feedback on the quality of vendor services. |

*To have a deeper conversation,
please contact:*

| | |
|---------------|---|
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"Making the middle office top of mind: Transforming the
asset management middle office to a bottom-line contributor."
PwC FS Viewpoint, February 2014. www.pwc.com/fsi

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