Managing Complexity:
Leveraging Opportunity Through Outsourcing in Canada

Few trends have drawn the attention of financial institutions in recent years quite like the accelerating growth in market complexity. A diverse range of converging factors account for this phenomenon, most notably globalization, regulatory and investor pressures, and the impact of new financial products such as derivatives. Yet, just as financial institutions must cope with the challenges of today’s operating environment, low investment yields are requiring them to focus more than ever on their core competencies to boost returns. However, for a growing number of firms, an important solution to today’s complexity lies in outsourcing strategies that help align their operating models with the significant opportunities for growth that exist in emerging markets.

The precise rationale to outsource varies by type of financial institution. Perhaps no market segment offers a more robust example of this than asset management firms. In Canada, as elsewhere, these firms are reassessing their investment value chains in light of market conditions. For insight into their findings, State Street partnered with International Financial Data Services (IFDS) and KPMG in 2011 to survey a cross-section of Canadian asset managers with the aim of identifying key trends that influence their decision to outsource and their success in doing so. The survey results confirm that asset managers continue to view outsourcing as an important approach to strengthening their core business, particularly at a time of significant competition for the talent required to drive and sustain state-of-the-art operating approaches. Critically, they recognize the value of a genuine client-focused partnership with the provider as the critical factor that will drive the success of this model.

The decision to outsource is fundamentally linked to a financial services firm’s business objectives. It lays the groundwork for a selection and implementation process that affects all aspects of a firm’s operations. A firm therefore needs to determine how the reasons to outsource can add specific value to its operations. Given the partnering role
that third-party providers should come to play in a firm — and the
difficulties inherent in shifting providers — making the right choice
is as important as the decision to outsource itself. By focusing on
each stage of this process as it relates to asset managers — from
business objectives to post-implementation assessment — the
State Street/IFDS/KPMG study reflects the value of approaching
outsourcing not only as a path to optimizing operational effi-
ciency, but also as a way to leverage the opportunities that today’s
environment presents.

Defining value

However, discerning the specific added business value of outsourcing
requires a keen appreciation of a firm’s strengths and challenges, as
well as an essential understanding of client needs and expectations.

As our study shows (see Figure 1), managers’ perceptions vary as to
where the precise value-add lies. The ability to maintain focus on core
business competencies was the most frequently-cited advantage of
outsourcing, as improved operational efficiency enables managers to
concentrate more of their resources on investment management and new
business development.

Nearly one-quarter of asset managers reported that fund accounting
was the most valued aspect of outsourcing, while others cited
outsourcing as a means to move into new markets, services and
product areas without incurring the high fixed infrastructural costs
that can accompany growth strategies. Though cost savings are
perceived as one of the key overall advantages of outsourcing, asset
managers emphasize that they seek the system and service that will
deliver the best value. Immediate cost savings are only one part of
the story. The most significant savings may arise over the longer term
as outsourcing removes the need to continually upgrade systems and
expertise at a time when the cost of doing so is high. Asset managers
need to operate efficiently across greater numbers of currencies,
share classes, domiciles and underlying instruments. Outsourcing
introduces far greater certainty into forecasting the cost of develop-
ment, enabling asset managers to turn mounting fixed costs into
predictable variable costs.

Technology and compliance also play sizable, and related, roles in
the value chain. Managers seek to tap into resource-intensive and
scalable information technology that can support key back-office
systems as well as rapidly evolving client reporting functions. Growing
risk awareness among clients underscores the value to managers
of expertise in risk management, fund compliance rules and
valuation methodologies.

Making the case

As asset managers weigh the options, they face an environment
where outsourcing can help them address many urgent chal-

1 State Street Center for Applied Research: Interim data from the CAR 2012 research study.
When asked to look ahead over the next decade, Canadian asset management firms ranked new product development and global growth as their top two business model priorities, reports State Street's Center for Applied Research. At the same time, risk analytics, distribution channels and regulatory compliance ranked as their top three operating model priorities. It may prove to be difficult for firms to execute on these priorities given their perceived gaps in talent identified by the same research. The largest gaps in talent are expected to be in the areas of understanding risk, assessing market conditions, and expertise across markets and asset classes. These assessments help to explain the growing trend toward outsourcing as a means for asset managers to gain a better grip on the complexity they face by delegating non-core functions. They also point to ways in which outsourcing can help managers wring opportunity from a challenging environment, particularly given the increased importance of flexibility and speed to market.

Firms across the board, and especially those that are independent and small to mid-sized, will need to focus on core functions, including sales, marketing and product development, rather than back-office services such as fund accounting and transfer agency. Moreover, providers’ state-of-the-art technology platforms enable these firms to enhance their service offerings, as well as to leverage economies of scale otherwise unavailable to them. As technology becomes a critical differentiator, managers can access these capabilities via third-party providers, thereby avoiding the growing year-on-year costs of investing in their own platforms.

Management firms also point to the access they gain through outsourcing to industry knowledge, new financial products, expertise and leading-edge skills that reliance on in-house capabilities tends to limit. In many cases they expect to translate this expanded expertise into operational efficiencies and enhanced performance that can help squeeze costs and lead to an improved bottom line.

**Selection: Need-based, firm-centric**

Gaining clarity about where outsourcing can add optimal value to the firm allows for more robust selection criteria. So, too, can an internal decision-making process that gains input from key stakeholders, both internal and external (see Figure 2). Their participation allows for a more thorough diagnosis of need, and of the outsourcing solutions most likely to address it.

The State Street/IFDS/KPMG research showed that the top client requirements of an outsourcing provider are:

- Transparent cost structures featuring competitively-priced solutions that can be easily modeled out for forecasting purposes
- Demonstrated commitment to best-in-class technology investment in scalable, flexible and risk-sensitive platforms, available to asset manager clients at a competitive cost
- Proven industry track record of a commitment to building long-term relationships based on a client-focused partnership model and cultural fit, and strong industry knowledge
- Client service characterized by proactive and cost-effective problem-solving, clear accountability, and a stable account management team strongly oriented to client needs

Reported selection criteria vary across asset managers according to size and business model. For example, small to mid-sized firms hoping to expand into markets in Asia and South America look for providers with multi-market experience that can also bring local insight and market-appropriate regulatory and tax expertise. By contrast, reputation awareness among bank-owned asset managers predisposes them to give particular consideration to the strength of a provider’s governance controls and valuation capabilities.

Whatever process is used to select a provider should also take into account the perceived barriers to transitioning from one provider to another. For small to mid-sized firms, making a switch can appear especially challenging, given their limited resources to devote to project management. In view of the perceived risks of business disruption, discrepancies in fund accounting and uncertainties inherent in changing legacy systems, asset managers will look for a partner with a strong track record in successful transitions.
Getting to success: critical factors

As Canadian asset managers’ experience with outsourcing grows, the State Street/IFDS/KPMG study underscores that the industry has formed a clear picture of the operational issues — current and emerging — to watch for as a firm transitions into a provider relationship. For example, constraints on innovation are an ongoing concern. New funds, often with complex fee arrangements and geographic diversity, require access to robust, flexible systems for launch within tight time frames as well as customized analysis. Managers are also watchful of valuation errors, a critical factor in preserving brand reputation. In addition, cost pressures continue to squeeze smaller firms, in line with pressure on assets under management.

Looking ahead, the same study shows that Canadian asset managers anticipate additional concerns, such as the expanding focus on reporting, causing accuracy and flexibility in data systems to grow in importance. Indeed, firms foresee leveraging, more than ever, providers’ insights into trends across the financial services industry. They will also want help in developing the broker-dealer and fund development sides of their business, alongside client needs.

Effectively addressing significant operational issues depends on a sound long-term partnership between asset manager and provider. Asset managers surveyed ranked such a partnership as the factor likeliest to determine outsourcing success, as well as:

- Provider flexibility that enables strong customized solutions, adaptive response to new products and service needs and the ability to grow with the firm
- Quality client service marked by engagement and fast response time
- A stable client account team in close alignment with the asset manager’s service, performance and quality values.

While outsourcing relationships can sometimes suffer from providers that over-promise and under-deliver, the industry has an opportunity to reinforce its value-add to asset managers. For those service providers that make the grade, huge opportunities will exist to deliver integrated, end-to-end solutions, whereby services such as fund accounting and investment operations are the linchpin for providing asset managers with a package of capabilities, from collateral management to derivatives servicing.

Outsourcing should not be undertaken without comprehensive due diligence. Yet in an environment marked by growing challenges for asset managers pressed more than ever to focus on core client services, it offers an innovative solution to meeting complexity head-on. Even more important, it represents a smart partner-based strategy for taking advantage of the opportunities that underlie the challenges that asset management firms now face. Increasingly, agility and speed to market will be seen as key differentiators across the industry, as regulatory requirements evolve and as risk-aware investors refine their expectations. Outsourcing can help achieve both when executed carefully with an eye to long-term business objectives as well as pressing operational priorities. On both counts, outsourcing offers asset managers a potentially strong path to growing their business into the future.