

ROUNDTABLE

Regaining product profitability post-crisis

The global economic downturn has left many in the financial services industry scratching their heads. And with investment managers' asset bases downsized, fund administrators must find new ways to turn a profit

Henry Smith: *These are challenging times for investment managers and fund administrators as the shrinking asset base of the former impacts on the profitability of the latter making, I'm sure, for some very difficult meetings between the two. Bernard, what do you see as the main challenges that your clients face, and how are you responding?*

Bernard Hanratty: I think our clients, no less than the administration community, are suffering from a challenge of product profitability. I think that as the investment managers look at their stable of products, they have their cash cows, and they have those products that have been nice to have on the shelf, but that are struggling in terms of their economics. That's exactly true in the case of the administrators, and the custodians who likewise have had cash cows and products in the embryonic component of their lifecycle, and I think it's those uneconomic product lines, both on behalf of the investment management community and on behalf of the administrators, that are subject to very close scrutiny. And there are many ways in which to address that, so it's not just about exiting the business. It's about looking for efficiencies and how you organise yourselves. It's about looking for potential partnerships. And about how you continue to meet the client's requirement without cutting off a potential lucrative franchise in the future and how to sustain that investment in the interim period.

Henry Smith: *Has the tougher operating environment led you to terminate relationships with any asset manager clients?*

Bernard Hanratty: I would imagine that all administrators have had discussions with customers around the economics of their relationship for some time. I think that's got to do with having horses for courses as you need a partnership

THE ROUNDTABLE PANEL



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whereby you can both grow together. Over time, Citi has done two things. One, we've spoken to our clients about encouraging them to collapse their product range, where they clearly have products that are unprofitable for them and unprofitable for us. And essentially asked our product management people to go to the marketing people within the asset management company and ask if the product is really viable in the long term. Usually, these are productive discussions that go very well for both of us, and we've had other discussions where it has become evident that we both have different views.

Chris Sier: That's interesting; having a very close relationship with a client, to be able to go to them to say, 'we think you need to consolidate your products', and ask whether they actually give a look-through into the performance of that product set?

Bernard Hanratty: They'll come to us and implore us to cut our minimum fees. And we say, we're at the bone already. In fact we'd like to hike your minimum fees up. Let's go back and have a look at the product dynamics. And one of the keys to developing the relationship is to be able to get through the chief operating officer or the vendor manager to the people at the front end of the business and to talk to them about their economics. And in not all relationships can you achieve that level of penetration as the asset management organisation.

Henry Smith: *Eric, what has been your experience at Société Générale Securities Services?*

Eric Dickinson: Well, we've had very similar experiences, particularly with some of the smaller asset managers that have been on reduced fees as they start to build their funds. They've come to us in exactly the

same way and asked to continue that, whereas we've been thinking about increasing those fees. But obviously it's all driven by the fact that the asset managers earn their income on the assets under management, and the asset servicers get their income largely from a basis points charge, so fees are being squeezed from every angle. On top of that, we were taken to the French Court of Appeal, which ruled that we had to reinstate more assets than we had assessed that had been lost by Lehman Brothers, which had been appointed as prime broker by an asset management client. This meant that Lehman had become a subcustodian of ours. The law in France places an obligation of restitution on the custodian, and we ended up having to pay, not a massive sum of money, compared with some of the cases going on in Luxembourg at the moment.

I think this will also lead to asset managers considering where they should domicile their funds, because in France if there's an obligation of restitution by the global custodian, then that jurisdiction is going to be much more secure for the asset manager than looking at other jurisdictions. If the same ruling does not result from cases going on in the courts in Luxembourg, then that could be the end of the asset management industry there, and hence the end of Luxembourg as a country. So from that perspective, I think it is inevitable that the Luxembourg courts will rule in the same way as the French courts in order to keep Luxembourg going as a country, let alone as an administration centre.

Chris Sier: The buck stops with the service providers when it comes to cutting costs. One of the experiences that we have – and we do a lot of benchmarking of performance of service providers, or asset managers and their service providers, operationally – is if margins fall on the service provider side their revenue starts to drop, then service quality drops.

Bernard Hanratty: Well, on the revenue side there has been a shortfall that isn't that well recognised, and it's not just to do with the value of assets declining, it's the fact that nobody's doing securities lending.

Henry Smith: *How are the smaller fund administrators faring? Are they managing to poach business from you larger players?*

Eric Dickinson: Well, obviously the smaller fund administrators have got a lower capitalisation, and although they may be able to offer high levels of service, the asset managers that are outsourcing to them do



have to consider the longevity of those organisations. I have heard that some smaller fund administrators have claims outstanding against them that are comparable to their capitalisation, if not exceeding their capitalisation.

Therefore, if people are purely looking at quality of service, they could end up in a very difficult situation if their provider goes under. So I would say that obviously if there are small-sized funds where a fund administrator would take it, then the asset manager may have no choice but to go to them, but then if those are small funds, and the fund administrator doesn't have the longevity, then the whole relationship of both the asset manager and the administrator comes into question, and whether they can continue in business or not is a real question. So I think, from my perspective, the people that are here to stay in terms of providing fund administration and outsourcing services are basically those that are part of universal banks that have got the very large balance sheets, and that can actually pay out when there are claims and continue providing the service.

Chris Sier: I think there is a market segment point of view here, though, Eric, isn't there? If you're a large global asset manager, then you have no choice but to >

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Eric Dickinson, Société Générale



go to somebody who is a large global service provider who has global capability.

John Donohoe: Large service providers cater for large asset managers. They build big industrial machines, which need volume to pay for themselves. If an asset manager is running a small fund, the wrong place to have it would be with one of the large service providers, because they cannot make money out of it.

They have higher overheads because they have a bigger infrastructure, as well as higher risk management costs and higher compliance costs. They have global networks that need global heads, which of course have to be paid for. For their part, large asset managers require a large service provider with deep pockets, both in terms of providing the infrastructure that they need to grow and develop – and, increasingly, these asset managers want to operate on a global basis, so the asset service provider has to be able to grow with them. They don't want to have 10 service providers scattered around the world. They might want two or three, just to provide some diversification, but it's not economic for the asset manager to have a whole load of service providers, and ultimately they realise that, and they consolidate into a smaller number.

Chris Sier: There is a flip side here, which is the capability. The small service providers have developed some interesting capa-

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Chris Sier, Alpha FMC

bilities, and it's a case of, 'how do big providers, who are slow moving, change control is a big process'? It's a big, slow-moving process. The asset managers want to develop boutique-like capabilities. Actually, the smart money might be on alliances between large and small providers, where the small providers are given the robustness of the balance sheet of the large administrator, and the large administrator benefits from the capabilities of the small provider. Now, it's tricky, because you have to write the contracts between the two, and the liabilities have to be very carefully weighted.

OUTSOURCING MODELS

Arun Sarwal: Having been both a client of a large outsourcing service provider, and now being a solution provider to them, if the asset managers have spent quite some time trying to make their operating model efficient, and if one of the means to do that has been outsourcing, my question is, have the asset service providers actually got an efficient outsourcing model to deliver the expectations that they have set themselves?

To my mind, a number of asset servicers are still living off liftouts and they're using multiple systems in the back office. We see middle offices fragmented. We see fragmentation in capability, not being able to deliver from a single source.

Chris Sier: I think there are two challenges here, Arun. One is having the appetite to

sort out this mess; and the other is having the competency to sort out this mess. So that competency is about defining what is commoditised and what is specialised, centralising in a hub, the commoditised components, and the specialised components can be in regional units, business units, fund accounting special rules for different locations. That's a pretty complex task, but interestingly, the other part, which is the appetite, is now becoming apparent.

Arun Sarwal: I think we've come to a very interesting point in time in terms of the maturing of the outsourcing business. It needs something like the current financial crisis to force people to look at their businesses and say, how do we make these more efficient? How can it be more productive? Because they've been living off a buoyant market, and there is a very significant investment to be made to cater for all the nuances. I'm not saying it's easy; it's not at all easy. I'm the first person to empathise, but at the same time I think if the provision of outsourcing services is going to be a successful business proposition, it's going to have to achieve a higher level of efficiency and scale.

Bernard Hanratty: I think there's a maturing in the outsourcing world for the reason that there hasn't been a large new outsourcing contract signed in the last two to three years. Most of them happened in the early part of the decade. So my point is that outsourcing service providers have either been successful in migrating off legacy platforms onto a common platform, which we happen to have done for our large outsourcings, or you're now committed to running multiple operating environments based on the legacy environment that your outsource party had. And that's the start of it, because the next point is, how do you then make those operating environments more efficient, and look the same in order to achieve scale efficiencies. If you happen to be all on the same platform but you still have a personalised environment for each outsourced party, then your capacity to scale up is very limited.

Chris Sier: Interestingly, your drivers for consolidation are the same drivers as the large asset managers, who are your clients, because quite often they want to consolidate their global locations into one single entity. It's mirroring exactly what you guys want to do, as well, which is to consolidate yourselves into one capability. What I found very interesting, though, is that the threat of an RFP by a large client makes providers sit up and pay attention very quickly, and to initiate change programmes that they've otherwise had lying dormant for some time.



Arun Sarwal: There should be a standard operating model offered to the clients. The challenge is that the clients are allowed to choose their operating model. So you have multiple instances of a strategic platform, but you can't get the consistency, and I think time has come to turn round and say this is the plain vanilla model, and maybe if you're a very large fund manager, which has got a huge amount of complexity with alternatives, then you can have a different model. That's what you've got to go for.

Eric Dickinson: You do need to have a standard operating model, and you do need to have a global strategic platform. The players that have been in the market for many years have grown up over a period of time and have, as you say, a mixture of platforms that they're using to deliver to the client.

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Arun Sarwal, DST Global Solutions

John Donohoe: I think it's important to be honest and say, what's the most important driver for managers to outsource? During good times, asset managers can pay for their own infrastructure, so it doesn't drive outsourcing. When times get tougher and fees go down, they start looking at outsourcing again. And that has been happening over the last six to nine months. They are looking at how can they reduce their cost base and make themselves more efficient, and that includes outsourcing.

Henry Smith: *What sort of outsourcing model are asset managers looking at now? Is outsourcing still going towards the modular, componentised approach, and away from the lift out?*

Chris Sier: If cost is the most important factor, there is no doubt the most cost efficient way to run an outsourcing deal is to give everything to one provider. But for the over-the-counter market, what people are looking for is capability, and if they want it, they will do it at a cost that is not necessarily the cheapest. They will take what the capability is. ■