Outsourcing 2.0
Some key trends in asset management

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Some emerging themes

► Second generation outsourcing – An emerging trend or just a renegotiation exercise?
► Emergence of the tri-party model for managers of life insurance assets – what does this mean for asset managers and their service providers?
► Single versus multi-provider strategy – is there an optimum model?
► Continuation of the first wave of outsourcing
► Extension of scope of outsourced services
► Consolidation of service providers
Is there really an emerging trend or is it simply a fee renegotiation exercise?
What is second generation outsourcing?

- Over the last 2 decades outsourcing in asset management has matured from custody, through to fund accounting, transfer agency and more recently middle office services.

Operations Value Chain

- Over this period it has been increasingly common for managers to change providers of custody services and to a lesser degree fund accounting and transfer agency.
- Second generation outsourcing describes the emerging trend for managers to revisit their providers or provider.
- Whilst a number of asset managers have considered the change and even embarked upon a selection process, to date very few have moved. But is a new trend emerging?
What is the case for change and why now?

- Expiry of contracts (and expensive exit penalties)
- Market for middle office services is maturing
- Dissatisfaction with the service quality from existing providers
- Desire to reduce costs through renegotiation of fees
- Desire to extend scope of outsource services
- Pressure from elsewhere in the group to change provider (to the group’s provider)
- Previous corporate activity has led to numerous providers and managers missing out on volume or bundled service discounts and increased costs for oversight and governance
But why still the inertia to move?

- Providers are now less willing to discount fees to win middle office business
- Corporate knowledge of the business that was outsourced has disappeared
- Perceived lack of service differentiation between providers
- Costs to change can be prohibitive – examples of cost of changing greater than the initial outsource
- The asset manager and service provider operating model is so integrated decoupling requires significant management effort and time
- ‘Better the devil you know’ mentality
- ‘Tupe’ rules means you may end up with the same team anyway!
What can managers do to address the challenges of second generation outsourcing?

Pre-selection
► Develop an operating model that facilitates a ‘plug and play’ model
► Ensure business requirements/current service providers documentation is kept up to date
► Invest time understanding how the current service provider is delivering the service

Selection process
► Use an accelerated selection process, focusing on key differentiators
► Consider bundling middle office with other mandates to increase attractiveness to providers

Implementation
► Ensure the new service provider covers the cost and some of the risk of transition
► Phase the transition to avoid a single 'big bang'
How are the service providers responding to this trend?

**Defensive (incumbents)**

- Improved service quality
- Expanding the service offering
- Enhanced relationship management
- Reducing fees?

**Offensive**

- Offering a pure middle office service and willingness to interface with third party fund accountants and custodians
- Willingness to cover client transition costs
- Development and marketing of robust transition capabilities
How will this conclude?

- More asset managers will consider a second generation but few will move unless it:
  - Results in a smaller number of providers
  - Simplifies the operating model
  - Is mandated by the group
  - Can demonstrate significant enhancement to service levels

- Increasing commoditisation of middle office services and standardisation of operating models will facilitate easier movement between providers

- However, service providers may increasingly question the commerciality of middle office only mandates and the funding of the transitions
The tri-party model for the managers of life insurance assets

What does the emergence of the model mean for the asset managers and service providers?
What does the traditional model look like?

Traditional model

- Life company
  - Capital
  - Annual fee
  - Investment return + administration + reporting

- Asset manager
  - Asset Management & limited Life Co. services
  - Bundled fees

- Service provider
The operating model between the life company, asset manager and service provider have been blurred for many years, particularly for middle and back office services.

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What are the drivers for the change?

- The relationship between life companies and their asset management subsidiaries has evolved
- Life companies are increasingly using third party asset managers to provide best in class capability
- This has led to increased in complexity in combining reporting on asset management activities from multiple sources
- In the wake of the financial crisis of 2008 life companies have become increasingly focused on having a deeper understanding of the risks of their investment portfolios
- The requirements of Solvency II are leading to a significant increase in the scope, level of detail, frequency and level of reporting on investments
How is the model evolving?

Life companies are no longer content to leave their asset managers to have exclusive management of the relationship with their asset servicing providers. They are increasingly assertive in demanding:

- The appointment of a service provider as the consolidator of all asset reporting from all managers
- A direct relationship with each fund accountant and custodian
- Service level agreements covering regular reporting of asset and risk data (to satisfy solvency II requirements)
- An increasing say in the selection of service providers
What does this mean for the asset managers?

Asset managers

► Reduced autonomy in selecting the service provider for the fund accounting and custody of the life mandates (typically the majority of the business)

► The potential for the life company to select a provider that isn’t the best suited to the needs of the asset manager

► The opportunity to introduce dual contracts

► Reduces the responsibility of the asset manager to provide oversight and governance over the services to the life company

► Increases the risk that the life company takes a more 'open architecture' approach to allocating the assets

► Prompts a redesign of the operating model, particularly a redefinition of responsibilities between the life company and the asset manager
What does this mean for the service providers?

Service providers

► Proactive targeting of life companies. Service providers are developing services to meet life company requirements
► The challenge of being selected by 2 buyers with very different needs and perspectives - and then the challenge of managing them!
► However, it can provide some protection if the asset manager is subsequently sold
Single versus multi-provider strategy

Is there an optimum model?
The outsourcing landscape

The asset management industry can be simply segmented by (excluding custody services):

1. Largely in-sourced model
2. Partially outsourced (typically transfer agency and retail fund accounting being outsourced)
3. Fully outsourced to a single provider (middle office, transfer agency, fund accounting)
4. Fully outsourced to multiple providers

We are seeing 2 opposing trends in the industry:

► Rationalisation of the number of providers used by an asset manager
► A shift towards a multi-provider approach
Why are some asset managers reducing the number of providers they use?

► As the service provider industry matures a 'one stop shop' is becoming more viable
► Benefitting from bundled services and volume discounts
► Reducing the burden and cost of the oversight and governance over the providers
► Increasing their prominence as a client to exert more influence on product pipelines and service enhancements
► A desire to create a more simple and global operating model
► To leverage the opportunities presented by UCITS IV (although not strictly new)
Why are some asset managers taking a multi-provider approach?

- A belief in a 'best of breed' approach – no one provider can deliver a world class service in all products and geographies.
- To manage the risk of failure or poor service from a single provider by easing the switch to an alternative provider.
- Maintaining a competitive tension between providers to help manage cost and service quality.
- A desire to extend the scope of the outsourced services (e.g., middle office) without being confined to the incumbent providers.
Is there an optimum model?

Theoretically, a smaller number of trusted providers can:

► Lead to more of a partnership approach
► Reduce the amount of 'education time' required by the asset manager
► Help the asset manager to become to a more influential client
► Enables the providers to add more value by delivering a more 'joined-up' service

► Whether managers are consolidating or moving to multi-providers there is some convergence on 3 (ish) providers (excluding custody)
  ► Middle office (plus investment accounting)
  ► Retail fund accounting (on and off shore)
  ► Transfer agency
Questions?
Thank you