

Investment Management Review

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Back-Office Outsourcing in the Funds Industry

About 20% of international managers in Asia have already chosen to outsource substantial parts of their back offices, and more and more leading firms are making the move.

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Investment fund companies advertise their performance, their research and their attention to client needs and security, but rarely do they boast about their back-office operations. That is because much of the back-office function has become a commodity, and indistinguishable from one firm to another. The capability of a firm's back-office operations generally does not enter the decision process when a client is looking for a new investment vehicle.

Smooth back-office operations, however, are a key part of the value chain between the fund's customers and their investments. Despite being near invisible, they are necessary for investment companies to operate efficiently. But the back office can become a weak link if it is inefficient or high-cost, affecting a firm's ability to grow, react to market downturns or run at maximum efficiency.

The setting up and running costs for an in-house back office can be quite substantial once the expense of floor space, technology and staffing are taken into account. Once that infrastructure has been put into place, it can also be costly to adjust according to shifts in the market. For example, a large investment firm with two floors of back-office operations in a prime office tower in the central business district of a major city will find it very difficult to cut overhead costs when business goes through a downturn. This was the experience of many firms during the 2008 global financial crisis.

Thirty years ago investment firms had little choice but to maintain large departments of back-office staff that added no strategic value but were vital to operations. Back then, firms did their own custody of assets and accounting, keeping all the important papers in fireproof safes and accepting costs as an unavoidable part of the business.

Today, investment firms do have a choice. They can relieve themselves of the cost and inflexibility of a large in-house back office by outsourcing all or part of these operations. This option leaves them free to manage money, deal with clients and carry out other activities that can differentiate them from their competitors.

The Rise in Back-Office Outsourcing

The global trend toward outsourcing parts of the investment fund business, from legal to accounting and marketing services, has been gaining momentum for decades. Back-office outsourcing, however, is relatively new and has developed in response to the changing nature of the fund industry and market conditions.

Since the 2008 crisis, the level of compliance costs in the financial services sector has risen sharply as regulators are demanding increased transparency and monitoring due to eroded investor confidence. This in turn has led to longer sales processes for distributors and added to the administrative burden of fund companies as they struggle to do what is required of them for the same fees they were receiving before the new regulations were imposed.

At the same time, over the years fund products have also become more complex, again adding to the back-office workload and requiring more expertise. A decade ago many firms offered simple domestic equity and bond products; nowadays, they may be offering derivative and structured product funds that raise the level of sophistication required by their back-office teams. Naturally a fund that requires a higher level of servicing can quickly absorb more than its share of administrative resources, making it unprofitable on an individual basis.

Adding to the complexity is that, whereas 30 years ago many investment funds were priced on a monthly basis, the industry standard has now moved to daily pricing. In addition, there is less tolerance for unit pricing

discrepancies and other errors. All of these things can be easily handled with today's technology, but fund companies must own this technology – and not only is it expensive, but it is constantly changing, creating a moving target for the firm and the fund manager.

Another major issue is the investment company business and operating model. While fund managers and sales staff are exclusively on variable compensation plans linked to the firm's profitability, most back-office staff are paid fixed salaries with low variable bonuses. This means that even as the market softens and revenues fall, the operational cost of the back office (salaries, the cost of floor space and so on) remains largely the same. As investment companies found during the recent crisis, there are just too many fixed costs associated with the back office. With little room for raising gross fees in the foreseeable future, following the 2008 crisis, the only option for fund companies that want to maintain their margins is to become more efficient. The challenge is how to achieve this without cutting corners and increasing operational risk.

The ideal solution would be to outsource everything from the dealer screens back to the origin of the assets. Whereas previously there was resistance to this idea – the fear being the loss of control – back-office outsourcing is increasingly being seen in terms of the advantages it brings. Although in practical terms, fund companies should only outsource as much as they feel comfortable (as regulators will still hold them accountable for the funds they manage and any errors that may occur), there are now a whole range of back-office outsourcing options available in the market. As well as daily support services, a sophisticated outsourcing provider can offer custody, securities lending, transfer agency, fund accounting, investment accounting and cash management functions. In some cases where clients have large existing back offices, a complete "lift-out" may be possible in which some of the client's staff and technology is incorporated into the outsource provider's own operation to create a smoother transition.

It is estimated that the activities that can be outsourced account for up to 40% of the overhead costs of running a fund, with savings made in cost of office space, salaries and technology investment. But even if back-office outsourcing does not result in substantial savings on a day-to-day basis, it still makes the business more scalable, provides enhanced operational efficiency and integrity, as well as improving the general quality of operational services.

Coming Now to Asia

The outsourcing of back-office operations has become standard practice in the United States and the United Kingdom over the past two decades, with continental European firms also rapidly turning to outside providers. Asia Pacific, however, has been slower to make the transition due to regulatory hurdles. However, with regulations easing and local firms increasingly adopting international best practices, there are more reasons than ever for Asian firms to consider back-office outsourcing.

According to Citi's estimates, up to 20 international managers are expected to enter the Asian funds market over the next two to three years. They are entering a market on the cusp of significant growth fueled by a rising middle class, high savings rates and steady growth in universal pensions across the region. Outsourcing their back-office operations from their initial move to the region could greatly enhance their success as they tackle new markets. By paring down the administrative workload, they can better focus on the aspects of business that truly make a difference. And with the global financial crisis fresh in their minds, they will be keen to avoid the costs of setting up a large in-house back office, together with the inflexibility and risks that this involves. Creating flexibility in this area is particularly relevant in Asia, which has a long history of highly cyclical economic activity.

Another reason why back-office outsourcing is pertinent to Asia is that many investment firms in Asia serve several jurisdictions in the region. From Hong Kong to Taiwan, Singapore and Korea, each market has its own rules and requirements. But despite their significant growth potential, many of Asia's markets remain small in comparison to the major western markets. Building in-house back-office operations to meet the needs of each jurisdiction would involve considerable costs, with little scope for scalability due to the limited market size. Outsourcing to a provider with expertise in compliance in multiple jurisdictions overcomes this challenge. Some outsourcing service providers use third-party subcustodians in smaller jurisdictions, trusting client assets to a local bank. However, a larger provider would be able to provide proprietary custodian services, allowing its clients to be assured of consistency of servicing across the region.

Conclusion

About 20% of international managers in Asia have already chosen to outsource substantial parts of their back offices, and more and more leading firms are making the move.

Established fund managers with existing in-house back offices are outsourcing them to reduce operational risk and increase efficiency while lowering fixed costs, while smaller companies establishing new offices are choosing outsourcing in order to allow them to focus on managing funds and finding new clients. As more Asian fund managers embrace outsourcing for its advantages, the business of providing such services will attract new entrants. This increased competition will, in turn, result in better pricing and another added benefit for investment firms.

Chris Ryan recently joined the Fund Services team within Citi's Global Transaction Services in Hong Kong in a senior advisory role. With more than 30 years of experience within the fund industry, which includes running some of the largest fund operations in Asia Pacific, he has expert insight into the challenges and potential opportunities facing investment funds today. ■

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