Keeping your foot on the outsourcing control pedal

By Nathan Travell, Milestone Group

milestone group

Transparency and control have become hallmarks of the financial services industry, with investors now fully aware that although a function can be outsourced, reputation management cannot.

Regulators globally have expressed concerns over how financial institutions that outsource business-critical functions operate their relationships with third-party service providers, whether they have robust and independent controls over any risk that might occur and, likewise, the potential implications of those service providers in-turn operating similar relationships with other financial institutions.

Indeed, transparency and control have become hallmarks of the financial services industry, with investors now fully aware that although a function can be outsourced, reputation management cannot. If a client's investment is affected, investors will not exempt their financial institution from responsibility just because an error arose at the outsourced partner.

Outsourcing arrangements are now prevalent across the fund management value chain. The asset managers, asset owners and administrators that are party to these arrangements have struggled to varying degrees with the challenge of delivering the appropriate level of oversight without replicating or 'shadowing' outsourced functions. The latter can have the effect of eroding the economic value that outsourcing would otherwise deliver.

The role of effective and independent oversight is now recognised as a positive and mutually beneficial dynamic.

Nevertheless, the role of effective and independent oversight is now recognised as a positive and mutually beneficial dynamic. Timely detection and remediation of service 'blips' prior to investor impacts occurring can strengthen the relationship and support a more objective understanding of the service interface.

Regulators identify risks in outsourcing chain

Under sweeping regulatory reform of Australia's $1.3 trillion superannuation funds industry, the Australian Prudential Regulation Authority (APRA) has outlined mandatory standards that require legally binding arrangements in place with outsourced service providers such as custodians, investment managers, asset consultants and financial planners. This follows APRA's recent review of the key risks and issues facing custodians that provide services to superannuation funds, in which it identified numerous issues, including a failure to perform sufficient checks of the data being incorporated into net asset value (NAV) calculations.

Meanwhile, the Monetary Authority of Singapore (MAS) issued a circular to remind financial institutions that responsibility for effective due diligence, oversight and management of outsourcing and accountability for all outsourcing decisions continues to rest with the institution, its board and senior management. MAS advised that a financial institution should "put in place proper framework, policies and procedures to evaluate, approve, review, control and monitor the risks and materiality of all its outsourcing activities".

Regulation in Europe regarding outsourcing arrangements in the financial services sector has been stringent for some time, with the UK's Financial Services Authority (FSA) mandating that a firm must retain the necessary expertise to supervise outsourced functions effectively and manage the associated risks. Similarly, the German Federal Financial Supervisory Authority (BaFin) released a circular in June 2010 stipulating that an investment company must always have available sufficient staff and resources to monitor its outsourcing arrangements carefully.

The US is not exempt either, with the SEC's Rule 38a-1 mandating registered investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund. This includes policies and procedures that provide for the oversight of compliance by each investment adviser, principal underwriter, administrator and transfer agent of the fund.

Stuck accelerator pedal: the manufacturing parallel

Despite outsourcing proving an effective element of a financial institution's operating model, without efficient and rigorous control, it can also result in additional risk. This is where parallels can be drawn with the need for efficient and rigorous supplier quality management in the manufacturing industry and, in particular, the automotive industry.

Using Lean Manufacturing principles, Toyota became the biggest car manufacturer in the world by sales volume in 2008, with its rapid growth and success largely attributed to its production system that focused on eliminating waste and inefficiency, and improving quality.

But, in early 2010, Toyota had to recall 2.3 million cars in the US to correct sticking accelerator pedals. Almost overnight, the firm's reputation as a high quality, reliable manufacturer was compromised. So what happened? While many industry commentators point to a combination of rapid growth and loss of focus on quality, others have gone further and identified that supplier quality management was the root cause.

An effective oversight function is essential for financial institutions looking to ensure that they are not currently cruising with a stuck accelerator pedal and, even worse, that they know nothing about it until it's too late.

Effectively, rapid growth had made managing and overseeing the myriad supplier relationships more difficult, especially when primary suppliers were also outsourcing parts of their supply chain as well.

One only has to consider the amount of outsourcing of fund processing activities that now takes place in the financial services sector to realise that a financial institution using an incorrect NAV price for example, has a stuck accelerator problem: large recalls resulting in financial exposure, loss of confidence resulting in damaged reputation and time and energy spent resolving the problems resulting in management attention being diverted from achieving business plans.

Reputational risk and restitution

An effective oversight function is therefore essential for financial institutions looking to ensure that they are not currently cruising with a stuck accelerator pedal and, even worse, that they know nothing about it until it's too late.

In a best case scenario, the error would fall under the market recommended tolerance the regulator has – e.g. 50 basis points of impact. Yet tolerance levels vary across regions and, even if it's only small errors that are occurring, eventually they will lead to a much bigger problem. To borrow the tag line from another major player in the automotive industry: 'power is nothing without control'.

Rigour in the oversight process is the key ingredient to ensure that the accelerator pedal does not get stuck.

Toyota's supplier quality management programme worked well before growth outpaced its ability to maintain the necessary levels of oversight as the value chain expanded and became more complex.

This was alluded to by the president of Toyota, when he noted in his address to US Congress that: 'I fear we may have grown too quickly'. Financial institutions face a similar danger as outsourcing initiatives gain momentum.

Naturally, the dimensions and the consequences will be different depending on whether the financial institution in question is operating under a business-to-business (B2B) or business-to-consumer (B2C) model. Those that directly hold liability with end-investors – and life assurance and larger pension fund operators in particular – will appreciate the gravity of what happened at Toyota. Some of the biggest restitutions of pricing errors have been in these segments, where firms typically have larger funds under management (FUM). Because they deal directly with the end investor, they are the ones that have to send out statements, accommodate the increased volume of enquiries at their call centres and remediate the funds in the account.

Conversely, fund managers that sell their product via fund distributors under a B2B model do not actually know who the end investor is. Regardless of the operating model, the risk remains the same. In the best case, the financial institution will need to resolve an internal or external audit 'black mark'. In the worst case, regulatory and reputational damage will be incurred and possibly substantial measures of restitution required. There is also the prospect of unforeseen head count increases to manually oversee these measures.

The fund oversight challenge

Once the outsourcing experience has begun, fund managers see that they are still operating an intricate but distributed process. They still need a range of management controls and checks, the same access to core data to ensure transparency, and the same ability to present analysis to various stakeholders. Accountability also remains fundamental to operational control. This is only effective where teams have the tools they need to reasonably perform their roles and can therefore be held responsible for outcomes. Exercising effective oversight to ensure accountability of service providers, at an operational level requires access to the right tools that provide complete transparency and timeliness of relevant information.

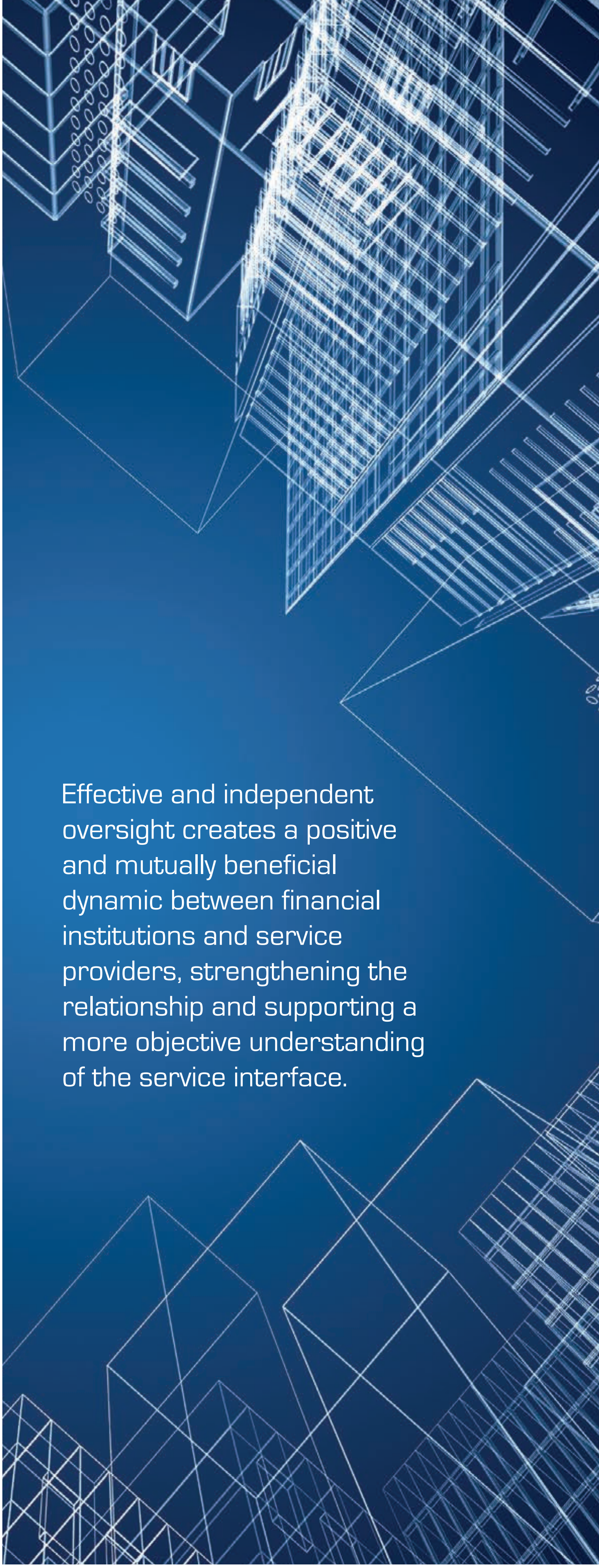
This is why firms devote so much time to due diligence and ensuring they select the right provider in the first place. It's also why there are internal teams dedicated to managing the relationship with the service provider and ensuring output is timely and correct. However, at the outset of the relationship, the oversight function is often not as comprehensively thought through as it could be. Oversight teams are established and are expected to remain small with limited resources. But they can soon balloon to become a more substantial operational unit in their attempts to stay on top of a wide range of outsourced functions, sometimes across several service providers.

The result is often an oversight function that has evolved organically, becoming challenged by competing demands of accuracy and timeliness with little time for detailed SLA reviews. This can lead to both pressured and inefficient oversight, or even inaccurate reviews that effectively allow service providers to 'mark their own homework'. Furthermore, in a typical scenario, team members receive non-standard reports and electronic files they have to feed into internal databases and spreadsheets. Once this information is consolidated they then have to conduct manual checks, reviews and analysis, thus the margin for error is clear.

Bringing rigour to oversight

In the world of manufacturing, supplier quality management protects against the risk of delivering poor quality outputs because the manufacturer does not have to check quality of input. For investment management firms, it's no different. Rigour in the oversight process is the key ingredient to ensure that the accelerator pedal does not get stuck.

Management of outsourced fund administration activities can be summarised in three key steps. Firstly, you need to understand the quality proc-



esses that the outsourcer has in place including how they ensure the quality of the data and services they themselves outsource. Secondly, you must regularly review this process and the output from it with the provider to ensure that the quality processes are both documented and actively pursued to ensure that quality processes operate effectively. And finally, you must put in place an active oversight function that independently tests and validates the quality of the goods being delivered to you by your service providers as a failsafe that they are continuing to meet your high standards of quality.

The oversight function should also follow another of Toyota's manufacturing principles: zero inspection. This refers to the automated detection of errors wherever possible, with human resources focused on responding to the exceptions and anomalies that are raised. In other words, having effective oversight in place does not call for large shadow teams of people destroying the original outsourcing business case financials.

Instead, a small number of skilled resources can support the risk reduction aspects of the business case by designing appropriate tests to measure the quality of supplied data. A suitable oversight control system will use the results from these tests to identify failures and alert users automatically. This way, issues can quickly be resolved with the relevant third parties before anything rolls off the production line.

Having effective oversight in place does not call for large shadow teams of people destroying the original outsourcing business case financials.

Automating fund oversight

Automation offers an answer to the challenge of ensuring rigorous oversight in the form of a purpose-built platform that can be applied across all functions relating to fund processing – regardless of whether these are handled in house or by a third-party service provider. This enables financial institutions to conduct validation and consistency checks, as well as compare results against SLAs while notifying, escalating and managing anomalies and issues. If a service provider plans to deliver a certain file, output or report at a certain time, an automated oversight solution can receive and validate results, or alternatively highlight that this hasn't happened. Based on business criticality and time sensitivity, such solutions can alert the right person and take the appropriate next steps.

Where organisations have multiple service providers and deal with more than one custodian, automation allows firms to aggregate information internally and, ultimately, to assess and compare performance through time. Top-line information provides 360-degree management views, while more granular information can be analysed to gain a clear and robust picture of key service delivery metrics. Fund managers can therefore base assessments of outsourced performance upon accurate insight rather than anecdotes and gut-feelings.

As demands for operational accuracy and efficiency continue to increase, financial institutions must start to look for ways to minimise costs, validate results and monitor service levels associated with their outsourced relationships. The financial services industry is now taking a fresh approach to the oversight of outsourcing and recent developments in technology can provide holistic solutions that increase transparency, efficiency and control across a fund's entire internal and external operations – regardless of the business model in place.

Crucially, effective and independent oversight creates a positive and mutually beneficial dynamic between financial institutions and service providers, strengthening the relationship and supporting a more objective understanding of the service interface.

Nathan Travell is a Senior Product Manager for Milestone Group based in London.

The Milestone Group solution

Milestone Group's pControl® Fund Oversight solution enables both asset owners and asset managers to automate their independent verification or oversight functions across a fund's entire internal and external operations.

Using an end-to-end control framework and standard process template to deliver a known end-state with defined target metrics, pControl Fund Oversight supports a range of risk and investment control capabilities, including:

NAV Oversight – independently verifies the movement of prior and current day NAV and unit price values to an independently generated NAV and price. A wide set of validations check movement in shareholder units, capital flows, dilution, fees, tax and spreads; while price correlation checks confirm consistency across funds, share classes and unit series.

Reconciliation – provides integrated matching of holdings, transactions and cash between internal systems and data from external service providers. This releases process efficiency and breaks the link between reconciliation volume and internal resource requirements in a robust and controlled processing environment.

Case Management – provides tracking, reporting and management control of service level issues, which are identified through all oversight processes. Once a case is captured, decisions are tracked and all events are captured throughout the complete life-cycle, providing the foundation for claims recovery and reporting against SLAs.

Fund Analytics – delivers simple point and click charting and statistics generation for unitised fund products, benchmarks and currencies. This integrates with NAV Oversight to use the returns for unitised funds and benchmarks in statistical calculations that highlight their performance and risk profile.

Data Manager – a data movement, transformation and validation engine enabling data connectivity within client environments and to industry-wide counterparties and service providers. It concurrently handles multiple data feeds in multiple formats to support upstream and downstream systems integration as part of a single end-to-end process.

Milestone Group's pControl is an advanced technology platform designed to service today's increasingly complex inter-funded product structures and related business processes.

For more information about Milestone Group, visit our website at:

www.milestonegroup.com.au

External/Internal Data Source
- Fund Prices
- Market Data
- Positions
- Trial Balance
- Unit Positions
- Commentary

Technical Validation
- Has all data arrived on time?
- Is data in the right format?
- Is data set complete?

Business Validation
- Validate fund NAVs and prices
- Raise exceptions via dashboards

Operational Control & Analysis
- Analyse exceptions and override
- Independent authorisation as required
- Valuations, NAVs & prices approved

SLA Monitoring

SLA reporting for:
- Data arrival
- Accuracy
- Approval times

Internal/External Data Destination
- Notifications to Service Providers
- Management Information
- SLA/KPI Review

Milestone Group is a global supplier of investment technology solutions for fund processing, fund oversight, fund distribution, tax & accounting and investment analytics.

London
68 Upper Thames Street
Vintners' Place
London EC4V 3BJ
United Kingdom
+44 20 7019 7190

Boston
225 Franklin Street
17th Floor
Boston MA 02110
USA
+1 617 986 0300

Sydney
Level 21
9 Castlereagh Street
Sydney, NSW 2000
Australia
+61 2 8224 2600

Hong Kong
Level 8
Two Exchange Square
8 Connaught Place
Central
Hong Kong
+852 2293 2629

Taipei
Level 37
TAIPEI 101 Tower
7 Xinyi Road, Section 5
Taipei 110
Taiwan
+886 2 8758 2877

www.milestonegroup.com.au

milestone
group