2011

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vol.99 (24.January.2011)

BPO utilization expands amid changes in Western asset managers' middle-office operations

Nomura Research Institute, Ltd.

With asset management companies' middle-office operations converging internationally and across different types of accounts, BPO (business process outsourcing) services' scope is expanding from the back office to the middle office. BPO's emergence as an option to improve competitiveness and operating efficiency enhances the Japanese BPO market's growth prospects.

Expanding scope of outsourcing in asset management industry

American and European asset management companies have been outsourcing a progressively wider range of operations over the past decade. Before 2000, they generally only outsourced back-office functions (e.g., securities custody, transfer agency, NAV calculation) to global custodians or fund administrators. Since 2000, their use of outsourcing services has expanded to encompass middle-office functions such as client reporting, performance measurement, and post-trade processing of various products, including derivatives.

Middle-office convergence and standardization of services

Back-office operations differ among asset management companies as a function of the regulatory requirements of the countries in which they operate, in addition to differences between mutual funds and institutional client (e.g., pension fund) accounts. However, the existence of prescribed requirements facilitates translation of back-office operations into routine procedures, enabling IT vendors and outsourcing service providers to standardize their services. Middle-office operations, by contrast, differ between companies and types of accounts, making them difficult to standardize. Efficiently providing middle-office outsourcing services was consequently seen as unfeasible.

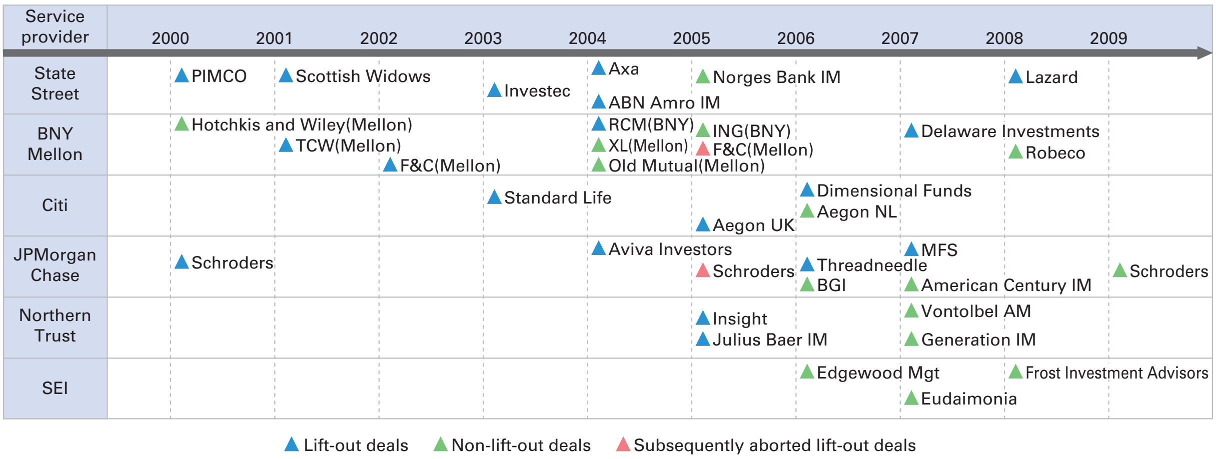
In recent years, however, middle-office operations have been changing. One such change is a shift toward real-time processing. For example, many institutional client services formerly performed on a monthly basis are now performed daily. Even hedge funds that trade in complex financial products generally perform fair-value measurement, performance measurement and analysis, and risk management on a daily basis. Middle-office functions for institutional client accounts have thus largely converged with mutual fund operations that have basically always been done daily. Meanwhile, mutual funds increasingly must not only calculate NAVs for investors on a T+1 basis (i.e., NAVs derived from current-day closing prices applied to the previous day's portfolio holdings) but also update and/or value portfolio positions on a T+0 or even intraday basis. In sum, as all accounts have come to be managed and valued on a uniform basis, middle-office operations are converging across all types of accounts. Additionally, the advent of Global Investment Performance Standards[1)] (GIPS®) has clearly expedited global standardization of performance measurement and analysis, both of which are middle-office functions.

For service providers, such changes in asset management operations have expanded opportunities to exploit economies of scale in providing outsourcing services. Meanwhile, asset management companies willing to utilize standardized middle-office services have started to actively do so.

From short-term cost containment to long-term business strategy

Asset management companies that outsource do so for various reasons. Many presumably do so to reduce and variablize fixed costs. Surveys[2)] have found that personnel costs' share of asset management companies' total expenses is around 70% in the US and 50% in Europe and Japan. We estimate that personnel expenses are split 40:60 between front office (e.g., portfolio management, sales/marketing) and other operations. Including IT system expenses' 10% share of total costs, non-front-office

Exhibit. Examples of major outsourcing deals involving European and US asset managers



Source: NRI America, based on various sources

operations account for 40-50% of total expenses. It goes without saying that cost control is crucial in non-front-office operations.

Although middle-office operations' output varies considerably between asset management companies in terms of quality and other such factors, middle-office operations are less differentiable than front-office operations. At the same time, they tend to be conducive to economies of scale. These characteristics make outsourcing of middle-office operations an option worth considering from the standpoint of operating efficiency.

A review of asset management companies' major outsourcing deals since 2000 reveals that lift-out outsourcing was prevalent in the first half of the decade (see exhibit). Lift-out outsourcing means that the outsourcer transfers to the service provider not only the outsourced operations but also its employees, IT systems, and facilities (real estate, etc.) hitherto involved in performing the outsourced operations[3]. For asset management companies, lift-out outsourcing has the advantage of enabling fixed costs such as personnel and real estate expenses to be quickly converted to variable costs[4].

In recent years, however, large-scale lift-out outsourcing deals have been decreasing in prevalence. While this trend partly reflects that service providers have been building their own service platforms, it has also been attributed to a change in mindset among asset management companies. For example, a US consultant highly knowledgeable about the inner workings of asset management companies has noted that they are now more likely to make outsourcing decisions based on longer-term business strategies such as curtailing IT investment inclusive of future costs of maintaining or expanding IT staff, instead of short-term containment or variablization of personnel expenses and other fixed-costs. In other words, asset management companies apparently believe that they are better off utilizing service providers' optimal, up-to-date infrastructure while retaining their human resources.

Japanese asset managers may contribute to BPO market growth

The asset management industry continues to broaden its frontiers in terms of investment strategy, global footprint, and diversification of investable assets. To capitalize on such trends, asset management companies cannot avoid upgrading the efficiency of their operational infrastructure. From the standpoint of highly improving competitiveness and efficiency, the decision of whether to insource or outsource is likely to perennially remain a key issue throughout the global asset management industry.

In Japan, however, asset management companies may be more inclined to decide to outsource in light of two major differences between the asset management business in Japan and the West. The first difference is that in Japan and a number of other Asian countries, asset management companies are tasked with calculating fund NAVs. For this reason, Japanese asset management companies have yet to utilize outsourcing services much, even for back-office operations. The second difference is that outsourcing of the portfolio management function has emerged as a viable business model in the Japanese investment trust business in recent years[5]. Companies that adopt this business model have no in-house asset management capabilities despite being in the asset management business. Instead, they outsource portfolio management to subadvisors while focusing their in-house resources on product design and marketing. Japanese asset management companies consequently tend to have higher middle-office expenses as a percentage of total expenses than their European and American counterparts. Given such a cost structure, Japanese asset management companies face greater pressure to improve their operating efficiency. These two factors bode in favor of rapid growth in outsourcing services' utilization in Japan.

Note

1) GIPS® are voluntary global standards prescribed to ensure fair representation and full disclosure of investment performance by asset management companies to existing and prospective clients.

2) Including Casey Quirk surveys and NRI surveys of asset management companies in Japan.

3) In the early 2000s, many outsourcing deals involved full lift-outs of personnel, IT systems, and facilities, but later lift-out deals were typically limited to one or two of these resources, not all three.

4) Lift-out outsourcing was advantageous to service providers also, because they initially did not have adequate resources to provide services. By acquiring these resources from asset management companies, they were able to increase their capacity to effectively provide services. Additionally, outsourcing service providers reportedly aimed to increase their market share by meeting the needs of asset management companies seeking to quickly reduce fixed costs. In some cases, service providers initially paid incentive fees to asset management companies to win outsourcing contracts before starting to collect service fees.

5) See Horie, Sadayuki, "Will Japanese asset management companies embrace front-office outsourcing?" (http://www.nri.co.jp/english/opinion/lakyara/2009/pdf/lkr200961.pdf).

Author's Profile

Yasutoshi Kaneko

Senior Researcher
Nomura Research Institute America, Inc.

E-mail : kyara@nri.co.jp

Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara