Investor &
Treasury Services

Focus on the middle

Does the middle office hold the key to sustainability in asset management?

Middle Office Services

Designed with flexibility in mind, our modular approach enables our asset manager clients to choose the functionalities they need in seeking to enhance their operating models.

Our custodian agnostic solution will deliver an end-to-end global platform for a seamless client experience.

RBC I&TS' Middle Office modules include:

- Collateral Management
- Transaction Management
- Corporate Action Management
- Investment Book of Record

Focus on the middle

Against the backdrop of growing competition, increased regulatory compliance and the ongoing evolution of technology advancement, asset managers are increasingly facing demand from their investors to provide enhanced offerings both from an investment and customer experience standpoint. All expected to be delivered at a lower price.

While the fundamentals of the trade lifecycle remain consistent, the traditional lens to improve efficiency has focused on the back office to free up resources for development in the front. Often overlooked, does the middle office now hold the key to sustainability by delivering the solutions needed while lowering operating costs?

Over the past few decades, outsourcing processes and tasks has gained popularity due to the associated cost saving benefits, improved efficiency and the opportunity to leverage smarter and more informative technology. For asset managers, back office processes are commonly outsourced but where does the middle office weigh in on the in-house versus outsource scale? There are a number of variations when describing middle office functionality but it generally falls under trade and collateral management, investment book of record (IBOR), corporate actions and data capture functions.

A number of existing processes can (and have to an extent) been improved either in-house or more commonly with the employment of a service provider who has made the investment into the technology and talent needed. But underneath these evident benefits, the real, untapped value middle office providers can offer today lies within the existing intelligence that is already being collated, reconciled, translated and reported. This powerful intelligence gained through data has the potential to change the way asset managers guide tomorrow's strategy and to influence the future course of the industry.

The Canadian comparison

The Canadian investment fund industry has more than $1.5 trillion under management[1] and continues to grow each year. With over 3,400 mutual funds[1] the competition to entice investors is fierce. Like their US and European counterparts, Canadian asset managers long ago recognized that while an attractive product offering will intrigue investors, the product must operate efficiently to keep fees low in realizing potential subscriptions.

Unlike their counterparts in the US and Europe however, while rationalization of the back office has been prevalent, this has not generally been extended to the middle office. Yet as its name suggests, the area is at the core of the investment lifecycle with significant potential to further deliver meaningful insight to enable investment decision making, finesse distribution strategies, improve operating models and create medium to long term strategic product development opportunities. All of which are the foundations in developing innovation within a streamlined environment.

1)2018 Investment Funds Report, The Investment Funds Institute of Canada

A middle office for the digital age

Ongoing cost pressures, the rising complexity of client needs across various markets and asset classes, together with regulatory change and cyber security threats are commonly cited as the key drivers to determining how strategic ambitions for both the middle and back office are prioritized.

When regulators set a date for expected completion of an initiative, the funds industry generally reacts knowing failure to comply will lead to repercussions. While the consequence of non-compliance to a new regulatory change is salient, it is less quantifiable to justify resource allocation in embracing (and ultimately investing into) the digital age. Yet while entering the third decade of the 21st century which will lead to an inevitable growth in underlying investors from millennials and generation Y, are there enough resources being deployed to deliver the products and services for these digital savvy generations?

Reactive change is no longer sustainable. The missed opportunity in dedicating resource for future prosperity could be more impactful on an organization than any regulatory censure might be for a missed deadline.

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Asset managers are not immune to the changes required to remain competitive and ward off potential disruption. The entire investment lifecycle needs substantial change if they are to maintain a sustainable and successful business model. Emerging technologies require emerging talent. Silicon Valley companies together with the multinational corporations recognized this need a number of years ago, and while the funds industry is making large investments into its technology and the talent that is needed to sustain and implement it, is there enough resource to go around?

The answer is debatable depending on the company trying to attract said talent. From front to back office, technology is the core enabler to firms that know change is necessary to remain competitive. While specialist companies in AI, cyber security, data and other technical disciplines are able to offer "off the shelf" solutions, there is an argument that this might not be sustainable given the ongoing and rapid evolution of these technologies will escalate costs to keep up with the advancements required. Service providers historically viewed as the fund administrator are now becoming the long-term answer. Many are investing significant amounts into their proprietary and client technology either in-house or with fintech partners.

The traditional asset servicer has reached a point in time where the decision to invest into or leave the industry has to be made soon. They are not immune from digital evolution and recognize that while more processes become automated, further demand for fee reduction will ensue. Technology advancements will soon pose the question of their value within the ecosystem. This has already inspired some to invest and change while others will need to follow or focus on other financial services they deem to be core. The traditional fund administrator will arguably be extinct within the next decade and a digitally enabled asset servicer is set to emerge in its place. The difference will be the technology, its people, their service model and the data solutions it can provide.

As asset managers evolve, they will need strategic insight that will help inform their decision making processes. Much of the talent to translate the data is in existence today but currently deployed in tactical activities, many of which could be fully automated. Trade management, liquidity management, an investment book of record, asset servicing and collateral management are the vital elements of an efficient asset manager's operation, much of which is performed by the traditional middle office. The expertise and knowledge of the people performing these duties can sometimes be underappreciated if not undervalued. Yet this is the area that sees and hears everything.

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To their left is the front office, to their right the back, nearly everything either goes through them or is generated by them. They are generally the experts who understand all aspects, rather than pockets, of the entire investment lifecycle and crucially understand where the challenges and opportunities to constantly improve exist. Yet, many are burdened with collating data from multiple sources, reconciling said data, translating and reporting it coherently before being able to organize and analyze the now old data for any valuable and/or actionable insights – insights that could contribute to improving performance i.e. intraday cash management, aid investment decision making, collateral optimization, etc.

Moreover, calculations that continuously need revisions due to human error and/or legacy technologies only exacerbate the problem. Asset managers are increasingly focused on how to better manage data to leverage predictive analysis to turn data into insights. Alleviating the cumbersome burden of data gathering can make this middle office expert more available for higher value activities. With it the potential exists in expediting operational and market risk identification, improving processes and quality of output to investors, plus helping to transform the existing business model fit for the 2020's.

Breaking the chains

While the concept of outsourcing middle office functionalities is not new in Europe and the US, the rationale as to why it is needed has changed significantly since the late 1990's. Much of it is a result of the changing technological and economic environment. Originally viewed (by some) as a move to reduce the cost of IT and human resource, outsourcing strategies have evolved and matured significantly. Those who have taken steps have seen minor adjustments to their headcount as they have generally deployed their talent elsewhere and subsequently many have increased their contribution to the organization.

Additionally, just as the need for faster and more meaningful data can assist in improving subscription generation and portfolio optimization, it too can help ensure compliance is maintained. While the responsibility remains with the asset manager, the outsourcing of certain tasks can equally help provide the necessary data to identify potential risks more rapidly and take necessary steps in the mitigation.

Given fierce competition in Canada, an ambitious asset manager will recognize the need to offer an array of investment products to its target audience and an efficient go-to-market strategy will be key. As investment ethics change with social pressure, products can be more complex and include additional markets and asset classes. A CIO does not want to be in a situation of being late to market due to being unable to support new structures as a result of outdated internal infrastructure. Outsourcing middle office functionalities can eradicate the need to invest into technology platforms to meet the market and regulatory requirements and therefore free resources for investment into commercial ventures.

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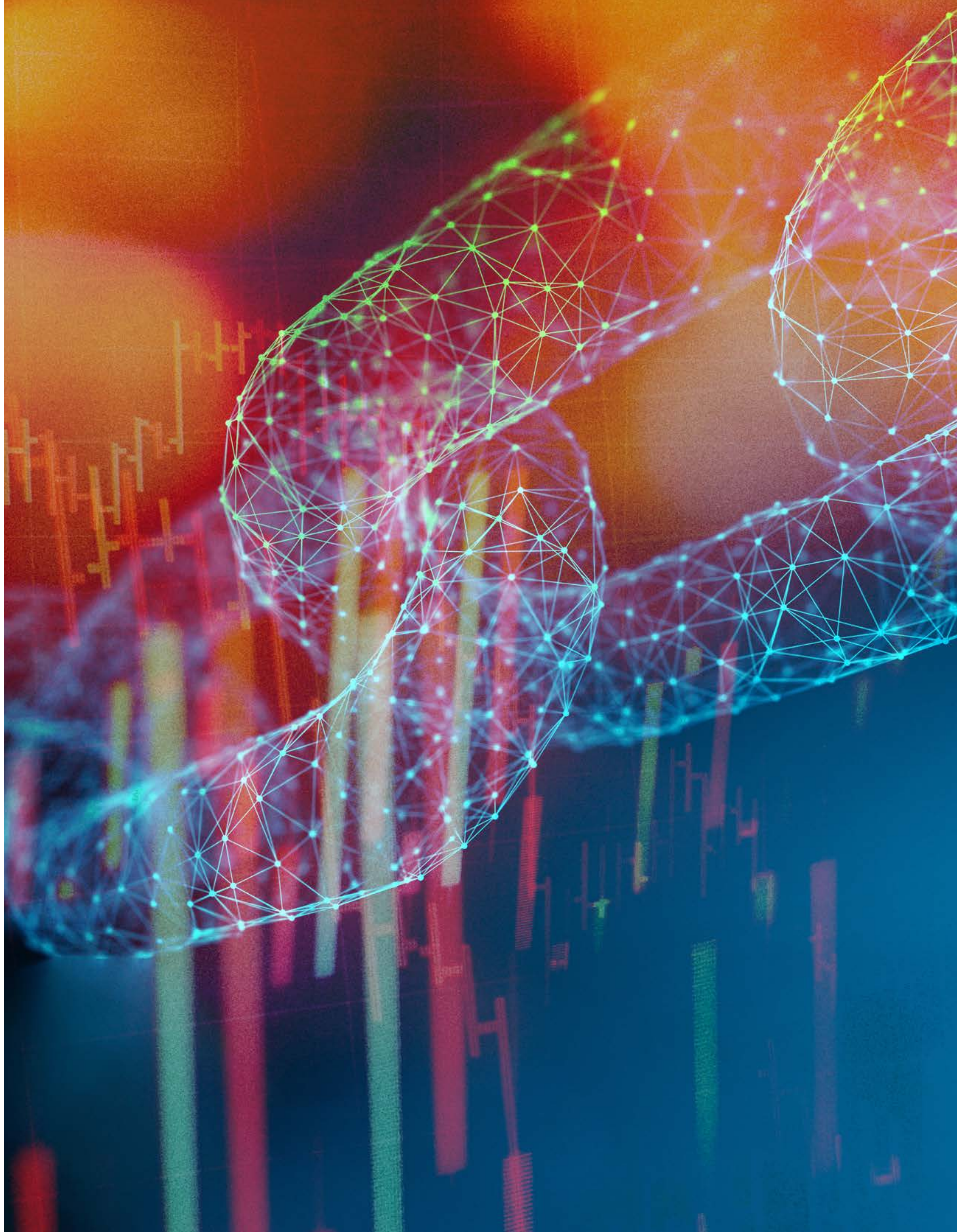
Middle office providers offer the scalability to help instigate new products coupled with quickly abiding by regulatory change and ensuring the appropriate integration with the rest of the organization plus other third-parties as needed (e.g. additional custodians, distributers, etc.). Additionally they offer the advantage of continued investment into cyber security – a significant threat that regulators and their governments are concerned about.

The rise of sophisticated technology has meant traditional functions within middle office have or can be automated which in turn has led to an abundance of data that, when mined correctly, delivers significant insight into helping improve strategic decision making processes. When relying on yesterday's practices, asset managers' opportunity cost can be estimated by losses associated with

- using outdated systems (security and calculation errors)
- time expenditure to populate excel spreadsheets and other manual processes
- siloed data not being reconciled and utilized to provide actionable value

Middle office service providers recognized this as one of the stumbling blocks for asset managers to evolve and have subsequently built their offering around automation and data enabled solutions. In essence the data partners for their clients, and the single aggregator of data to provide the golden source for insights.



One size does not fit all

If exploring the idea of outsourcing disciplines, it is fundamental that conversations make operational and strategic sense. The decision must also be heavily dependent on the status of the current IT available, the availability of existing talent both from an investment and technology perspective, but above all the defined objectives as to what the asset manager is trying to achieve in the long-term in staying ahead of their competitors.

As an example, the implementation of Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) collateral rules for non-cleared derivatives has increased the volume of transactions requiring collateralization and formalized the process for market participants. As a consequence, asset managers engaged in OTC derivatives have found it increasingly inefficient to gather the appropriate data to ensure they are remaining compliant and taking the correct actions in a timely manner.

> Asset managers engaged in OTC derivatives have found it increasingly inefficient to gather the appropriate data

Without appropriate centralization and automation, the determination of the potential impact collateralization has on the business can take time to answer. So too is the understanding of any threats, opportunities and options available. Generally, the asset manager has the talent already in-house to answer these questions, but not the IT infrastructure to provide the relevant data.

On the flip side, asset managers considering outsourcing need to be careful to ensure that the service provider they are in discussions with can support their aspirations. A firm managing a complex multitude of different asset classes and diverse investment strategies needs to be comfortable that the solution being offered is not deemed "off the shelf" which might cause issues further down the line.

The right collaborative partnership

Defining a strategy collaboratively with the chosen provider is the best approach. Certain functionalities should be introduced in a timely manner to make sure they are effectively fulfilling the objectives and will help with the change management process while making the service provider accountable in delivering what is needed.

Flexibility, trust and commitment are key to employing the right partner as there is significant risk in moving middle office functionalities. It is crucial that the service provider provides the infrastructure through a phased approach to allow the asset manager to continue meeting their short term goals and where possible, the service provider should facilitate this process with full transparency. After doing so, the solution should allow the asset manager to realize additional revenue by having the additional time and resources to onboard new funds and mandates more efficiently.

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From a long term perspective, an asset manager's ambitions will gain a significant improvement as the much needed resource will convert even further from a tactical or reactive culture to a strategic one.

Does the success of a middle office outsourcing strategy rely on a collaborative partnership? It is paramount that the provider has a deep understanding of the asset manager's business model, their ambitions and internal culture. There might be a resistance or at least some concerns internally to the change which needs to be managed appropriately by both parties. From the service provider's perspective, helping to embrace the forthcoming change through education and transparency is needed. Likewise, as middle office solutions tend to require long-term commitment it is important that the provider can demonstrate theirs in delivering the expertise needed.

About RBC I&TS

RBC Investor & Treasury Services (RBC I&TS) is a specialist provider of asset services, custody, payments and treasury and market services for financial and other institutional investors worldwide, with over 4,500 employees in 17 countries across North America, Europe, Asia and Australia. We deliver services which safeguard client assets, underpinned by client-centric digital solutions which continue to be enhanced and evolved in line with our clients' changing needs. Trusted with CAD 4.3 trillion in client assets under administration[1], RBC I&TS has been rated by our clients as the #1 global custodian for eight consecutive years[2] and is a financially strong partner with among the highest credit ratings globally[3].

Contact your local RBC I&TS representative to learn more about how our middle office solution can help you.

1 RBC quarterly results released May 23, 2019
2 Global Custody Survey, Global Investor ISF, 2011 to 2018, unweighted
3 Standard & Poor's (AA-) and Moody's (Aa2) legacy senior long-term debt ratings of Royal Bank of Canada as of May 22, 2019

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