INSIGHT

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OPERATIONS OUTSOURCING STRATEGIES: TRENDS AND CHALLENGES IN ASIA

OUTSOURCING OF MIDDLE AND BACK OFFICE OPERATIONS TO THIRD PARTY SERVICE PROVIDERS HAS BEEN ON THE RISE IN ASIA AND HAS GROWN TO COVER A WIDE RANGE OF ACTIVITIES. THIS ARTICLE PROVIDES INSIGHTS INTO THE CURRENT TRENDS IN THE REGION, THE KEY CHALLENGES FACED BY FINANCIAL INSTITUTIONS THROUGHOUT THE DECISION PROCESS AND LASTLY, OUR APPROACH TO HELP THEM OPTIMISE THEIR OUTSOURCING STRATEGIES.

Introduction

Financial institutions have been relocating middle and back office functions across the globe for more than a decade. While at the beginning the exercise primarily consisted of offshoring to in-house service centres based in low-cost countries, the **financial industry has now become more receptive to outsourcing to third party service providers**.

The primary reasons given by financial institutions explaining their growing appetite for third party service provision are threefold:

- Specialists can help them manage the intensification of the regulatory compliance burden in middle and back office operations.
- By delegating to third parties processes that do not differentiate their products and services, they can refocus on their core competencies.
- A number of technological innovations, such as cloud based computing, have enabled third party service providers to offer more flexible and sophisticated solutions.

The resulting **shift from in-house offshoring to outsourcing to third parties**, which accelerated in Europe and the United States alongside the implementation of the first post-crisis regulations, **is now catching up in Asia**.

Outsourcing Trends

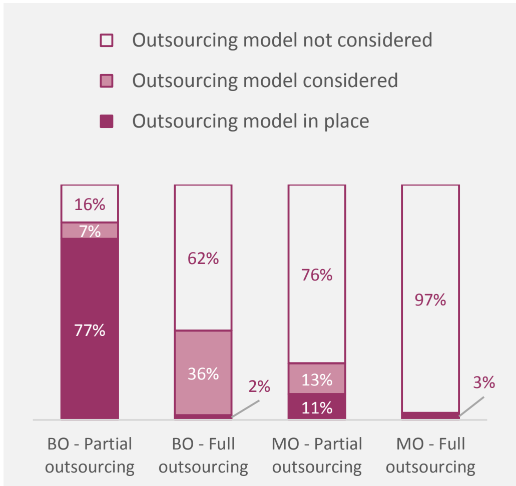
We are observing four main trends in Asia.

Full back office outsourcing and partial middle office outsourcing are on the rise.

The financial industry has already adopted a partial back office outsourcing model to reduce the need to invest in system infrastructures and facilitate business expansion. **As regulatory and financial pressure increases, a growing number of institutions are moving one step further towards fully outsourcing their back office platform**. For example, Deutsche Bank have entirely outsourced their Asset and Wealth Management back office operations in Singapore to Avaloq Sourcing, on the back of Avaloq's successful track-record in Europe.

Middle office outsourcing has been to date more limited. Financial institutions are more reluctant to externalise those processes as they are more integrated with their core front office activities and usually cover sensitive client facing activities. Nonetheless, **appetite for partial middle office outsourcing has grown**, notably in the asset management industry, as a result of the wider range of capabilities developed by technology and service providers.

ILLUSTRATION 1 – OUTSOURCING STRATEGIES OF FINANCIAL INSTITUTIONS IN ASIA



Source: survey conducted by YouGov on behalf of BNP Paribas[1]

Outsourcing has become a long term strategic game.

Outsourcing is now typically considered by financial institutions in the context of their long term strategy as **it enables two prevailing strategic goals**:

- **Refocussing on core competencies** to increase business performance and strengthen risk management; and
- **Automating processes while "variabilising" the cost base** to protect profitability in a subdued business environment.

Financial institutions are reducing their involvement in peripheral activities, such as middle or back office operations, to **cut down the time and money invested in upgrading legacy systems, hiring resources and managing staff turnover**. The benefits of outsourcing have become all the more important given that the recent pace of regulatory changes has accelerated the frequency at which organisations need to realign or upgrade their platforms.

[1] BNP Paribas, "Middle and back office outsourcing for banks and brokers – Preparing for the international stage – Asia", November 2014

Outsourcing also provides benefits from a cost management perspective. It can **offer an effective way of engaging in robotic process automation** without having to invest heavily in infrastructures and human capital. Instead, financial institutions can rely on vendors that specialise in establishing and running automated and standardised solutions. In addition, outsourcing can **accelerate cost reduction during periods of lower business activity**. Indeed, more and more vendors offer cloud-based "Business Process as a Service" and pay-per-use models where customers are charged based on the number of transactions processed instead of the number of licenses or nodes utilised.

Banks tend to favour partnerships with independent specialist providers.

Financial institutions looking at outsourcing their non-core middle and back office operations have two main options. They can either turn to another financial institution that has developed a scalable solution, such as the "Post Trade Plus" platform developed by Citibank and UBS, or partner with an independent specialist provider. We have observed to date a preference for the later.

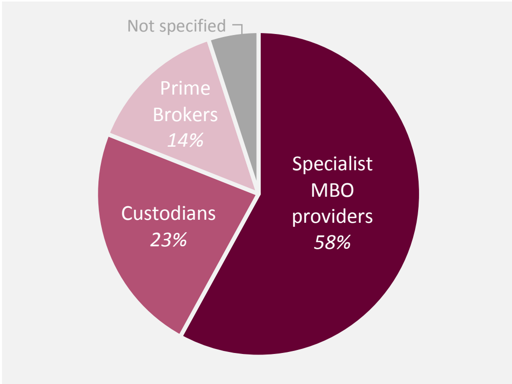
ILLUSTRATION 2 – EXAMPLES OF SPECIALIST BACK OFFICE OUTSOURCING PROVIDERS IN ASIA

Source: Sia Partners research

This **preference can be explained by the growth and maturation of the independent specialist outsourcing market**. Barriers to entry have decreased on account of falling computing costs, which resulted in intensified market competition. Financial institutions have therefore access to a growing pool of potential partners who are striving to differentiate themselves by adapting to the technological curve and building cost-effective innovative solutions faster than their competitors.

Another explanation is that **operational partnerships between banks can raise strategic concerns**, particularly between the larger players. On one hand, institutions outsourcing their operations may be unwilling to give competition access to their transactional flow. On the other hand, outsourcing providers may hesitate to facilitate the growth of key competitors. Nonetheless, inter-bank partnerships are also growing but at a slower pace compared to outsourcing to independent specialists.

ILLUSTRATION 3 – PREFERRED OUTSOURCING PARTNERS IN ASIA



Source: survey conducted by YouGov on behalf of BNP Paribas[2]

Price remains the primary consideration but other factors are becoming increasingly important.

As the sophistication of the components outsourced and the focus on "outsourcing risk" increase, the primary factors that banks and financial institutions consider when selecting an outsourcing partner are evolving.

While price remains the core differentiating element, **quality of service, relationship management and communication practices are receiving greater attention**.

Based on the trends observed in the more mature European and North American markets, one might conclude that the quality of service and relationship management will be the primary decision drivers in the near future.

[2] BNP Paribas, "Middle and back office outsourcing for banks and brokers – Preparing for the international stage – Asia", November 2014

Strategic Challenges

Despite outsourcing becoming more prevalent in Asia, the exercise continues to pose a number of challenges to financial institutions, especially during the strategic decision phase.

Managing regulatory constraints and requirements

One of the key steps of the decision making process is the assessment of the feasibility of the outsourcing project from a regulatory perspective, which is often more complex in the Asia Pacific region than in Europe or the United States.

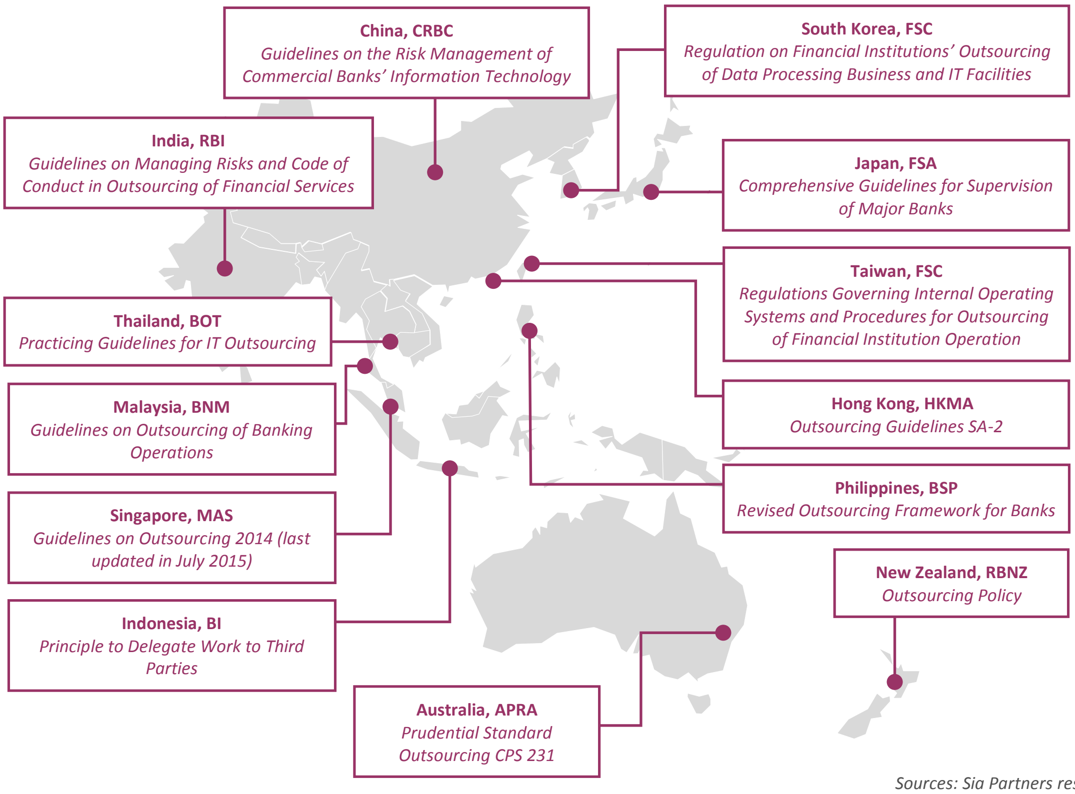
Firstly, the **sheer amount of regulations that come into play can appear to be overwhelming**. Due to the fragmented state of the Asia Pacific regulatory framework, a financial institution looking at establishing an outsourcing arrangement at the regional level will on average have to consider more than ten distinct regulatory frameworks.

Secondly, **outsourcing regulations across the region are not homogeneous**. For instance, regulatory approval requirements and timelines differ from one country to another. While jurisdictions like India or Vietnam do not impose pre-approval or pre-consultation requirements, some regulators, for example in Hong Kong or Singapore, expect to be approached months before the target go-live date.

Thirdly, **regulatory approval criteria are not always clear-cut**. Key aspects commonly considered by regulators include the protection of client interests and data privacy, the robustness of the risk management framework, the control retained over data stored in offshore servers and the impact on local employment. In some instances, no clear guidelines are given regarding pass criteria or materiality thresholds.

It is thus imperative to thoroughly analyse the impacts of local regulatory requirements and to factor those in the decision making process. **By-passing this critical step at the inception of the project has the potential to significantly delay the launch, materially affect the return on investment or jeopardise the feasibility of the project**.

ILLUSTRATION 4 – KEY OUTSOURCING REGULATIONS IN ASIA PACIFIC



Sources: Sia Partners research

Selecting a partner in line with the sourcing strategy and risk appetite of the bank

Outsourcing decisions for critical activities such as clearing, settlement or valuation, can have a significant impact on the servicing of end-customers, business profitability and the risk profile of the organisation. Therefore, it is essential to select a partner in accordance with the organisation's outsourcing strategy and the boundaries set by its risk management framework. This is however easier said than done.

The first challenge arises from the growth in external "fintech" options available. The proliferation of potential candidates has made the shortlisting process more time consuming and resource intensive.

Moreover, even though outsourcing has been receiving greater attention from senior executives, frameworks articulating the strategic objectives and boundaries within which the organisation is willing to operate are not always clearly defined.

Finally, **as regulators and internal control functions turn up the pressure on "outsourcing risk", the risk assessment process has become more complex**. In a survey recently published by Risk magazine[3], outsourcing was ranked the sixth largest source of operational risk facing financial institutions. Key sources of risk that organisations have to consider include data security, compliance with privacy laws, vendor concentration, reputation, political and social stability and fourth party risk introduced by sub-contracting arrangements.

More often than not, the selection process will involve trade-offs that need to be carefully thought through.

Identifying the optimal outsourcing location

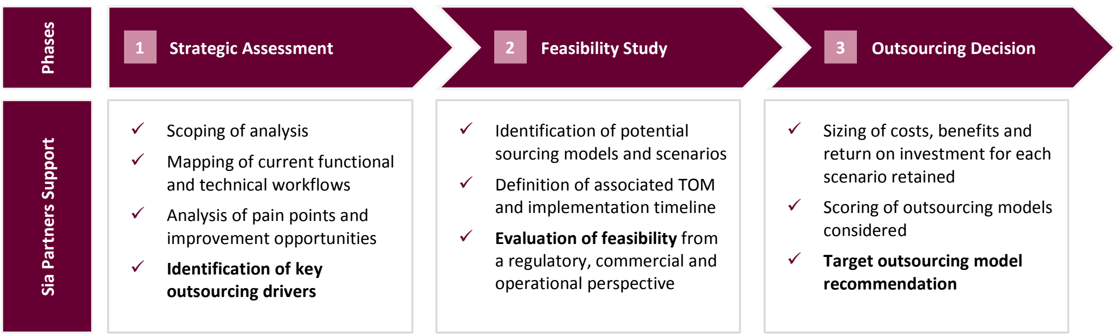
To make an informed decision that will meet their long term objectives, organisations have to analyse in details the benefits, costs and risks of possible outsourcing locations, factoring numerous parameters including but not limited to wages, real estate cost, taxes and geopolitical stability.

The key challenge is to **find an optimal outsourcing location under current market conditions, while recognising and anticipating the need to remain flexible going forward**.

Sia Partners Approach

Sia Partners have a comprehensive experience in advising banks and other financial institutions on middle and back office outsourcing strategies. We have developed a structured approach, articulated in three phases, to help our clients make the most of their outsourcing opportunities:

ILLUSTRATION 5 – SIA PARTNERS SUPPORT ON THE OUTSOURCING DECISION MAKING JOURNEY



As pressure mounts to increase efficiency, cut costs and focus on core competencies, a growing number of financial institutions in Asia have to rethink their outsourcing strategy. If you are interested in discussing how we could support your organisation on its decision making journey, please contact our teams in Asia.

[3] Risk.net, "Top 10 Operational Risks for 2016", January 2016

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About Sia Partners

Founded in 1999, Sia Partners is an independent global management consulting firm with over 700 consultants and an annual turnover of USD 125 million. The Group has 17 offices in 13 countries, including the U.S., its second biggest market. Sia Partners is renowned for its sharp expertise in the Energy, Banking, Insurance, Telecoms and Transportation sectors.

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