Building a high-velocity back office: A view from consultants

Institutional investors are increasingly under pressure to sustain a high pace of innovation, while also cutting costs. The solution? A high-velocity back office.

Across the global asset management sector, an unpredictable business environment is straining the back office. A range of factors, including the development of new front-office products, digital transformation, entry into new markets and tightening regulatory requirements are forcing change. This, according to industry observers, creates a new set of challenges for institutional investors.

In this inaugural edition of "Building a high-velocity back office," State Street's article series exploring how institutional investors can optimize their back-office operations, five top industry consultants share firsthand insights into the crucial role a robust administrative side plays in a firm's growth strategy. A common theme is velocity. This series specifically explores the need for speed, and the role it plays, in enabling a highly effective back office. While there's a significant body of existing research focused on broadly optimizing back-office operations, this series uniquely focuses on strategies for building speed into back-office operations.

"Five to ten years ago, the back office wasn't on the radar," says Roland Kastoun, Asset and Wealth Management Consulting Solutions Leader, PwC US. "Asset managers focused on raising money and investing. But rising complexity has exposed chronic underinvestment in the back office."

> "We're heading toward a situation where there's no front, middle and back office, as we're used to thinking about them."
>
> **Roland Kastoun**
> PwC US

Increased complexity stems from multiple factors. One is the expansion of investment vehicles, including exchange-traded funds and separately managed accounts as well as the emergence of novel asset classes like cryptocurrency. Another is increased investment in private markets, bringing a raft of challenges, including around managing data. Furthermore, the product feature of direct indexing adds another layer of complexity. And as competition intensifies, many asset managers are looking to new geographies, which requires meeting new compliance obligations under unfamiliar regulatory regimes.

Essentially, this constitutes a dual challenge for the back office. As Daisy Tung, Asset Management Leader at KPMG, summarizes: “Firms need both to reduce costs and get information to the right people faster.”

The back office remains a small part of asset managers’ overall cost base, but it can potentially significantly contribute to company margins. “For a typical asset manager, the back office is seven to 10 percent of total costs,” explains Adrian Costin, Managing Director at Deloitte. “Let’s assume that an asset manager’s overall margin is in the range of 28 to 36 percent. If they can drive back-office costs down 10 percent, that would lead to a 120 to 180 basis-point increase in margins.” In a competitive environment, that is a prize worth pursuing, he notes.

“Where the back office plays a key role is in scalability and flexibility,” says Costin. “For example, if your back office is not able to support the firm’s expansion into new asset classes, it could potentially impede the firm’s growth. Asset managers need the ability to expand into new asset classes and new geographies — to scale faster and launch products faster,” he explains.

Agnel Kagoo, US Consulting Sector Leader for Asset Management at KPMG, emphasizes the impact of product lifecycle effectiveness. “Along with the scale and speed of launching products, it is essential to also monitor and manage effectiveness of products and sunset in a timely manner,” he says.

Therefore, the pace of change combined with the pressure to deliver cost efficiencies requires a flexible, adaptable back office that can operate more nimbly than ever before.

Three principles for building a high-velocity back office

The experts point to three principles to help institutional investors build a high-velocity back office.

1. Capture added value from outsourcing by consolidating providers

Outsourcing has long been a go-to strategy for the back office — from custody to transfer agency and fund administration. But today's challenges are forcing a shift. According to the experts, consolidating providers is an effective tactic for unlocking value.

Costin notes that significant inefficiencies are created by outsourcing to different providers across both functions and geographies.

He recounts the experience of a Europe-based alternative assets manager: "They were using 20-plus providers for back-office services across the globe. The oversight and management [required] alone is going to [make this arrangement] highly inefficient," he says.

Alternative managers, in particular, have prioritized best-in-class providers for every function and geography, and at substantial expense, adds Costin. "The more efficient model is to do more with a single provider," he observes. "Even if that provider is not best-in-class in every single geography, it's still better to use that single provider across multiple geographies."

The consolidation trend is growing, observes Sarah Simmonds, Partner, Asset and Wealth Management Consulting at Alpha FMC. "There is pressure for consolidation across functions, both horizontally and globally," she says, adding that managers in different geographies approach outsourcing differently. US firms, for example are exhibiting nervousness around consolidation, following initial problems.

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> **Adrian Costin**
> Deloitte

But that is changing. “Managers are more open to those conversations now, given the economy we’re in and the pressure to drive down costs,” she notes.

“If you consolidate providers across functions, we estimate the savings are sizeable — 15 to 20 percent,” says Simmonds. “If you do that globally, the savings could be as much as 25 percent.”

According to Simmonds, managers want to know three fundamental things about outsourcing: How long will it take for the back office to transition? What are the average cost savings? And how much quicker will they be at adapting to change? Typically, back-office transitions can be delivered faster than managers expect, resulting in substantial savings.

2. Invest in data and technology platforms

The second key principle for a high-velocity back office is targeted investment in technology. It is a critical driver of systemic simplification, says Tung.

The back office’s role in maintaining the official record for investors, clients and the organization has always been labor-intensive. As Tung notes, the traditional response to rising requirements is to increase resources, with a predictable impact on cost. However, technology allows managers to change that equation. “Firms are trying to bend the cost curve to improve their margins, while getting better at providing information to the right people, faster,” she explains.

One priority is to invest in the firm’s data ecosystem. “The key question is, ‘How can we master and govern data better to produce useful analytics and provide the information we need,’?” says Tung. Firms are also prioritizing automation, simplifying their tech platforms to reduce the need for manual

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management and correction, or implementing workarounds. “A typical back office today might have 10 to 15 types of reconciliation to undertake across different platforms,” she explains. “In the future, you may have none.”

The back office also requires a viable strategy for artificial intelligence (AI); it is already falling behind the front office, argues Kagoo. “Clients have finite budgets, and they prioritize the front office because that’s where they seek differentiation,” he explains. “So, that’s where use cases for AI have started.”

In the back office, the conversation is less about competitive differentiation and more about realizing efficiencies. That may mean working with outsourcing partners on AI. “Think about where you can build on somebody else’s innovation,” suggests Kagoo. “There’s a lot of merit in working with partners to tap into their innovation.”

Leaders also need to plan for how AI will affect the back-office talent profile. “We predict that the demographic of back-office personnel is going to be very different in 10 to 15 years’ time,” says Kagoo. “Today, it’s typically an accounting major with a tech minor, but that will be reversed.”

Deloitte’s Costin agrees that investment in technology is paramount, but emphasizes that it may not need to be done in-house. “As an asset manager, I would weigh the return on investment between tech transformation and outsourcing options,” he says, “especially since a considerable number of asset managers still operate back-office functions in-house. Previously, both asset managers and asset servicers expanded resources to manage manual procedures and attempted to control costs by offshoring resources,” he explains. “Going forward, efficiency enhancements and value-added insights will be achieved through platform

upgrades and rationalization, adoption of intelligent automation/AI, and data modernization. However, the investments can be done at scale by asset servicers."

3. Build in flexibility and agility

As institutional investors become increasingly reliant on a diversified product offering, the need is growing for a more modular, flexible back-office operating model. For example, today's back office may have optimized data, workflows and reporting for public markets, but it struggles to adapt those legacy systems to the growing requirements relating to private markets, which may have very different data availability and reporting schedules.

"Existing platforms and systems don't accommodate that complexity," asserts Kastoun. "But if I'm a large institutional investor with 10 to 20 percent of my assets under management in private markets, I don't want 10 different reports that are disconnected between public and private. I want one single view of my investments." Existing tools are rarely able to meet that expectation.

That disconnect highlights the need to implement modular and flexible systems that are designed to accommodate emerging requirements.

Transforming the back office

For many asset managers, efforts to boost back-office capability are overdue. The priority is keeping pace with fast-evolving market needs. But, for some managers, the future lies in reenvisioning the role of the back office entirely.

That means the back office must pivot from being a value enabler to a value creator, suggests Kagoo. "To help shape new products, people in the middle and back offices need a seat at the table throughout the product life cycle." The velocity of product launches is unlikely to decelerate, so back-office input from the outset of product development — for example, about data availability — helps ensure that new products are commercially viable.

The case for strengthening the back office is increasingly compelling, but asset managers often put off such investment, says Kastoun.

However, firms are playing a high-stakes game if they delay this investment, he warns, as potentially costly problems can emerge. "There's a tipping point for firms when it comes to investing in the back office: Is it causing delays in product launches? Is it leading to adverse investor experiences? Is it introducing regulatory risk?"

The experts agree that firms can greatly benefit from accelerating efforts to build the high-velocity back office required to keep the business as a whole ahead of the curve.

The right back-office servicing model can help do a lot: unlock growth, gain efficiencies and seize new market opportunities.

State Street Corporation
One Congress Street, Boston, MA 02114-2016

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