Remote Working, COVID-19 and Middle Office Outsourcing

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With COVID-19 lockdowns and the likelihood of ongoing workplace interruptions, asset managers have been challenged to find ways to maintain operations amid great uncertainty. During the headiest days of the pandemic crisis, the stock market underwent the largest daily price swings since the 1929 crash. This extreme volatility and resulting massive increases in transaction volumes would have presented challenges in normal circumstances, but they were even more difficult for asset managers to handle in a newly remote environment. With black swan events happening more frequently, many firms are forced to prepare for such scenarios to reoccur.

Asset managers with preexisting service provider partnerships were mostly successful in scaling to volume spikes and quickly adapting to a remote environment. The success of middle-office outsourcing relationships during this crisis has prompted many firms to consider how such a partnership can help insulate them from unexpected volume spikes, future lockdowns and increasing economic volatility.

Challenges adapting to a remote operation

As COVID-19 hit the U.S., the need to relocate staff off-site, or even furlough them, became prevalent across industries. In early March, there was a great deal of uncertainty about how quickly companies would need to react, but by the end of the month, this sweeping change emptied offices in every major city in the United States. Financial services firms were in a relatively unique position of having business continuity plans (BCPs) to comply with FINRA Rule 4370, which requires firms to have written BCPs relating to emergencies or significant business disruptions. A global pandemic is undoubtedly an excellent example of both.

Although FINRA Rule 4370 gives firms flexibility in designing their BCP, it must include the following elements:

- Data backup and recovery (hard copy and electronic)
- All mission-critical systems
- Financial and operational assessments
- Alternate communications between customers and the firm, and between the firm and employees
- Alternate physical location of employees
- Critical business constituent, bank and counterparty impact
- Regulatory reporting
- Communications with regulators
- Assurance that customers have prompt access to their funds and securities if the firm determines it is unable to continue its business

Source: FINRA Rule 4370. Business Continuity Plans and Emergency Contact Information.

Most firms had plans in place that were refined over years of disaster response, but few companies addressed the impact that a global pandemic, which would force employees into isolation over multiple weeks and months, would have on their operations. Generally, asset managers' disaster recovery (DR) and BCPs are about short-term solutions for technical issues, e.g., electrical outages, fires, flooding and weather disasters. Solutions are focused on phases. First, what is the allowable downtime before resumption? Can it be waited out for one to two days? And second, if it lasts for two or more days, we switch to an off-site DR data center/full operations relocation, including work from home options.

With the COVID-19 workplace disruption, asset management firms had to implement in-home capabilities for all aspects of the business. They needed to ensure that client services, asset management and operational support were all fully engaged and supported for an indefinite time. This is a complex challenge, especially because there can be no prioritization between asset management and operations—they are dependent on each other, require technology support and are vulnerable to errors particularly around cash management, trading and settlement.

Because of the need to fully disperse employees, BCPs that focused on short-term disruption factors were insufficient. With this unprecedented workplace interruption, staff needed to be able to work from home for an extended period and be fully functional with all activities covered and all supporting technology available. Requirements that were often undocumented in existing BCPs included the use and availability of computers, monitors, printers, scanners and adequate (and secure) internet access in a home-office setting.

Investment operations roles require access not only to internal systems and technology, but also to industry and counterparty tools such as the DTCC suite, SWIFT, ISS, Bloomberg and custodians. Additionally, the work disruption also forced asset managers' front offices and trading desks into remote settings. This separation from internal teammates was challenging for many to navigate, and the lack of direct access to analytical tools and trading applications added to these difficulties.

During this time, it was not just the investment operations staff who were required to relocate. Counterparties, brokers, custodians, consultants and their clients were also required to work from home. This compounded operational risk due to the dependency on each organization to ensure staff had adequate access to technologies required to fulfill their roles in the investment life cycle.

Mitigating risk through outsourced operations

Most asset management organizations have secure logins so they can access cloud-based applications from any location with the correct hardware/software and secure sign-on information. However, there is a sizable share of asset managers who still manage some portion of their data and software on-premise. While many of the firms that run on-premise software also have remote access through a secured connection (e.g., Citrix) in place for operational access, in the immediate aftermath of lockdowns, many technology teams needed to continue accessing the office while following cumbersome regulations to ensure social distancing. This placed an undue burden of risk on employees who needed to access data stores, terminals and other installed systems. Despite the prominent trend of asset management software moving to a SaaS or cloud-based deployment, a partially on-premise technology model is still commonplace today across the front, middle and back offices of many asset managers.

Firms with service provider relationships in the middle and back office may have had a different experience. Many were able to diminish risk to employees with simplified technology requirements. With comprehensive support for browser-based applications, asset managers with outsourced operations teams could more quickly adapt to a remote environment. This access enabled them to perform their required functions with no need to service or access on-premise operations technology. In addition to operations, those who took advantage of hosting capabilities of their service providers for their front-office tools were able to pivot to their home offices more quickly.

Along with providing a cloud-based model to clients, service providers often have multiple locations supporting their business both locally and overseas as part of a 24/7 operational model. This model presents an opportunity for failover if business resumption is required for one or more locations. Resilient outsourced operations teams have built the capacity and expertise to allow for such a reallocation of resources during interruption or high-impact time. As the impact of the COVID-19 pandemic unfolds globally, local lockdowns continue to be implemented, causing unpredictable business interruption. A middle-office service provider can quickly pivot activities from one location to another with limited or no impact to service. On the other hand, most asset managers with fully insourced operations are not equipped with the flexibility to shift between geographies as outbreaks and local regulations dictate.

Besides the above challenges, many asset management firms have invested heavily in an open concept design on their operations and technology floors to promote close proximity collaboration. Others have moved to “hoteling” as a way to limit designated space and save on real estate costs for employees who may travel often or are not working out of the same office location every day. As reopening strategies are being developed, asset managers are looking at the cost vs. benefit of reconfiguring these offices to allow for social distancing once it is safe to return people to the office. The added real estate and construction costs of such a project alone may drive consideration of outsourced operations. While middle-office outsourcing providers have operated efficiently in the current work-from-home environment, there will always be incentives to have a portion of their operations teams on-site to further the value proposition to their asset management clients. As such, investing in plans to bring key staff back to the office will be a priority for service providers. As reported in a recent *Ignites* article, SEI has started to safely bring personnel back into the office, focused on “a subset of those roles that are best performed in an office to improve delivery quality, reduce risk and improve efficiency.”[1]

[1] Jackie Noblett, “SEI Brings 200 Staffers Back to U.S Offices,” *Ignites*, July 24, 2020.

Meeting the demands of market volatility

When markets are moving—whether in response to changing business conditions or a global pandemic—the result is increased trading volumes, unscheduled cash flows, large valuation changes and concurrent swings in collateral requirements. Investment operations teams supporting all of these events need to be on alert, nimble and, in some cases, on double duty to ensure accurate processing and timely movement of assets and cash. According to an April article published in *Global Custodian*,[2] two of the largest global custodians reported a rise of at least 50% in back-office transactions in March versus the first two months of 2020.

One of those custodians also provides middle-office services, and it reported an increase in middle-office transactions of over 80%. Similarly, SEI saw a doubling of middle-office transaction volumes in March compared with the January/February average. While trading volumes and corresponding liquidity needs were at the forefront during this time, they were not the only operational segments under high-risk conditions. In cases where collateral is required, market swings require diligent monitoring since collateral movements will certainly increase, sometimes exponentially. An asset manager's internal team can quickly become overwhelmed and overworked by the increased requirements in a market facing the unprecedented volatility we experienced in the first half of 2020. The typical one or two collateral calls per week may have increased to several calls a day during mid-to-late March. Many asset managers can confirm mistakes occurred in the spring, and some can unfortunately attest to costly financial errors and procedural violations that took place during this time.

Firms that leveraged a third party providing trade confirmation/affirmation, settlement and collateral management were at a unique advantage in handling market volatility. Service providers are well-suited to handle these activity spikes with global staff that supports multiple asset managers and thousands of accounts across markets, counterparties and custodians. This scale provides built-in opportunity to reassign and/or reallocate experienced resources across the organization and between firms. During a time of extraordinary strain on operations, asset managers with outsourced middle-office support were able to better maintain stability and mitigate risk.

Operational resilience in the aftermath of lockdowns

Given the challenges posed during the COVID-19 pandemic, there is a compelling argument for outsourcing. A key reason is that asset managers can focus on their core business and hire a service provider to manage their operations, typically a cost center that requires significant oversight if managed internally in an asset management organization. By employing a third-party service provider, the asset manager does not have to maintain the supporting and necessary investment operations activities and tools, such as accounting, performance, reconciliation, collateral management and settlement systems as well as the technology that supports unique investment vehicles or asset classes.

A middle-office partner will also maintain links to external counterparties, data providers and clients. They are responsible for hiring and training operations and technology professionals, who will be cross-trained and reallocated when additional resources are required. This is an indirect cost to the asset manager, and the benefit is the ability to manage more assets, take advantage of new investment opportunities, introduce new products and maximize investment performance for their clients without managing the real estate, technology and human assets required to run an operation.

[2] Joe Parsons, "BNY Mellon and State Street shed light into back-office pressures from COVID-19 pandemic," *Global Custodian*, April 20, 2020.

Asset managers have come to recognize the numerous benefits of outsourcing their investment operations to a service provider, including:

- Economies of scale on commoditized functions (e.g., trade operations, reconciliation, investment accounting, cash management)
- Technology infrastructure that is supported and upgraded by the provider
- Highly skilled and seasoned operations professionals, low turnover
- Cross-training, resource sharing, and reallocation in peak times
- Support for investing in new strategies or asset classes
- Disaster recovery/business continuity best practices
- Variable fee schedules based on AUM, asset types, transaction volumes, portfolios, accounts or functions

This last point is often viewed as a key benefit, especially during economic uncertainty. Firms that do not outsource their middle office, by and large have a fixed cost in terms of people and technology, in addition to other indirect costs driven by full-time employees. Moving to a service provider model with a variable fee schedule that will contract if AUM or the number of accounts decrease can be appealing to protect costs during a downturn. Further, during a business disruption, having a service provider for investment operations lessens the burden on the asset manager, who can focus on the challenges of continuing portfolio and risk management and managing client relationships while the service provider handles the operational activities and data generation. This model demonstrates not only the ability for the manager to maintain business continuity but how disaster recovery and business continuity plans complement each other for success.

The decision to outsource and the ensuing transition

While many industry pundits believe that the disruption to operations caused by the pandemic will drive interest in outsourcing in the long run, it's not necessarily expected that decisions will be made and deals will get inked in the near term. An early 2020 *Ignites* article[3] discussed this point, citing reasons including, "the uncertainty of the current economic environment, as well as the challenges of installing new systems and processes with most employees working from home."

Though it may be challenging for asset managers to determine outsourcing suitability, then subsequently evaluate and select a provider and navigate the transition during the coming months, it is far from insurmountable for those interested in moving forward despite current market uncertainty. Many firms expected the work-from-home "experiment" to last a few weeks to a few months, and as such, focused purely on tactical delivery of contractual obligations. Now that many firms are anticipating a remote working environment lasting six to nine months or even longer in the "new normal," they realize that putting on hold strategic decisions that are intended to help drive future growth will only prolong the inevitable and could result in a competitive disadvantage. Firms that invest in upfront planning, proper allocation and dedication of resources' time—which, in some cases, may require additional support from the service provider and/or external consultants—and that recognize evaluations and transitions may take longer than they would during pre-COVID-19 "normal times" will be most poised for success.

[3] Jackie Noblett, "Covid's Impact on Outsourcing: Good for Demand, Bad for Execution," *Ignites*, April 28, 2020.

Navigating a path forward during the pandemic

Anecdotal evidence suggests that in the first few weeks of the pandemic, as all parties became acclimated, there was a period of confidence building. Is all the data accurate and available? Are people ready and available to respond to and fix issues? Can service levels be met? We've got it—or do we?

As weeks turned into months, events have shined a light on the benefits of having a partner in investment operations. Asset managers using a service provider have the advantage to focus on their business and investment management capabilities while the service provider guarantees human and technical support for investment operations, and most importantly, takes on the burden and risk of timely trade operations, collateral and cash management, as well as ensuring accurate data is supplied to that asset manager in keeping with service level agreements.

As the remote working environment becomes the new normal, sophisticated growth-oriented managers currently employing an in-house operations model need to reevaluate their operational infrastructure and take advantage of the learnings of the past few months. Why wait until they return to their offices to focus on strategic initiatives? Indeed, the days of 100% of staff being on-site in urban offices may never be the norm again. Those who think, "Why not now?" instead of those wishing to return to the days of old, will have a leg up on those who wait.

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*Based on *Pensions & Investments'* Largest Money Managers 2019 ranking.

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