
The opportunity to outsource operations has never been more prolific or held more promise for asset management firms seeking greater business opportunities by having the ability to focus on their core competencies, while achieving improved efficiency and cost savings.

Middle-Office and Back-Office Outsourcing: Successful Lift Outs or Co-sourcing Arrangements Hold Promise for Japanese Asset Management Firms

By Nomura Research Institute and BNY Mellon Asset Servicing

As asset management firms spanning the globe continue to sharpen their focus on improving efficiency and turning fixed operational costs into variable costs, outsourcing back-office and middle-office functions remains an area of opportunity. However, not all asset management firms embrace the spectrum of outsourcing arrangements, particularly because these arrangements may be affected by traditional employment models. While US and European asset managers have the flexibility to select the outsourcing arrangement that best aligns with the firms' objectives, asset managers in Japan are often challenged by a long-standing labor tradition of the "lifetime employment" model. In this paper the Nomura Research Institute and BNY Mellon discuss global and Japanese outsourcing trends, the labor tradition challenges that outsourcing providers face in Japan, co-sourcing as a potential outsourcing model, and a successful "lift out" at an asset management firm, which demonstrates how providers can overcome these challenges when working with Japanese asset management firms.

Background

Long-term or lifetime employment security enjoyed by many in Japan has been a cornerstone of the country's corporate culture and a symbol of its cohesion as a society. A full-time employee of a firm in Japan can most likely expect employment until the common retirement age (60). The virtues of lifetime employment have included employee loyalty and the firm's willingness to invest heavily in human resource development that allows for the accumulation of skills for the benefit of both the employee and the firm. However, the global financial crisis of the past few years has altered the priorities of asset management firms worldwide in several ways, including the need specifically for Japan to re-examine labor customs as they pertain to outsourcing operations.

Reflective of their commitment to lifetime employment, established Japanese asset management firms would most likely only consider a "lift out" outsourcing arrangement. In a lift out arrangement, a group of employees is transferred to the ranks of the outsourcing service provider, while the functions they previously performed remain relatively intact. Newer entrants into the Japanese market, however, are more likely to enter into an outsourcing arrangement where functions not currently being performed by the firm would be immediately outsourced. This would enable Japanese asset management firms to honor their labor tradition while benefiting from the operational efficiencies and other advantages a fully outsourced model has to offer.

Global and Japanese Outsourcing Trends and Suitable Models

As a result of market conditions and several key trends in financial services, asset management firms have renewed their focus on their core competencies and are taking a closer look at their operations. While operating costs remain fixed in both prosperous and poor economic conditions, the past decade has caused many asset managers to re-evaluate their operations by considering the strategic benefits of outsourcing non-core functions to a third party. The contracting economic environment over the past few years, increasing pressure on firms to raise and retain assets and improve investment performance, the development of more complex products, changes in how products are distributed, and a more onerous regulatory environment have all had a profound effect on how asset management firms conduct their business. The opportunity to outsource operations holds promise for asset management firms seeking greater business opportunities by having the ability to focus on their core competencies, while achieving improved efficiency and cost savings.

Co-sourcing enables the asset management firm to have the flexibility to outsource their middle-office with a pace that best suits their needs.

In particular, the outsourcing of middle-office operations such as trade capture, corporate action, data management, and investment accounting have increasingly gained more attention as back-office operations such as fund administration, fund accounting and custody have been outsourced for several decades in the United States and Europe. Despite the many reasons for asset managers to outsource their operations, Japanese asset management firms have been slower than U.S. and European firms to adopt this approach because of the strong Japanese labor tradition of lifetime employment. Recently Japanese firms have stated to Nomura Research Institute that if they were to embrace more use of outsourcing services, lift-outs would be the preferred model. Even if Japan's labor customs were similar to those of western nations, perceptions persist that having a highly skilled internal investment operational staff is still a valuable commodity and lift outs may be the ideal way to prevent an outflow of talent from the asset management industry globally.

Co-sourcing is another viable outsourcing arrangement that offers a more transitional approach for Japanese asset management firms without the limitations of a first generation lift-out type of outsourcing model. In a co-sourcing arrangement, asset management firms can implement the full spectrum of services in either a bundled or unbundled fashion, including: trade communications, matching and notification; reconciliation; accounting services; cash management, corporate actions; performance & risk analytics; portfolio service; compliance reporting; information delivery; data management; and client billing and statements. This gives the asset management firm the flexibility to outsource their middle-office at a pace that best suits their needs.

Case Study: Outsourcing Lift Out of Asset Management Firm for Middle- and Back-Office Operations

Nomura Research Institute and BNY Mellon conducted a case study on Delaware Investments ,a member of Macquarie Group, which outsourced its middle- and back-office operations to BNY Mellon through a lift-out outsourcing arrangement.

Delaware Investments®' (\$171.6 B AUM of US\$ billion as of March 31, 2012) search for an outsourcing provider required more than operational due diligence. The selected firm would need to have as part of its corporate culture a deep investment in and demonstrated commitment to its people; and the ability to deploy the Eagle Investment Systems' technology platform.

After an extensive selection process narrowed to three potential outsourcing providers, BNY Mellon emerged as the most suitable provider with the core attributes essential to Delaware Investments.

Several factors encompassed Delaware's decision to choose BNY Mellon over competing firms, including:

- People as a core brand value embedded in the BNY Mellon culture
- Extensive experience as an outsourcing service provider that understands the potential challenges involved in mixing corporate cultures
- Sensitivity to the uncertainty that many of the lift-out employees may express when undergoing such a change
- Commitment to technology build out based on the Eagle Investment Systems platform

Realized Benefits

As a result of the outsourcing arrangement with BNY Mellon, Delaware Investments realized several significant benefits, including:

- The provision of continued employment for existing operational staff
- Formation of a strategic relationship that allows flexible business expansion
- Cost avoidance for ongoing technology, training and system development

Provide Employment for Existing Operational Staff

While cost savings was an important consideration for Delaware Investments outsourcing its operations, the firm was adamant about its employees' job security. The employees overall had a long tenure and the firm placed a high importance on maintaining a culture of long-term employment. As such, with 'people' as one of the three pillars of BNY Mellon's culture, Delaware Investments was outsourcing to a firm that would understand how to successfully plan for and accommodate the transfer of operations and employees from one corporate culture to another. A service provider should be well aware of the sensitivities involved in mixing corporate cultures and the uncertainties that many of the lift-out employees experience when undergoing such a change. BNY Mellon developed a detailed plan to work closely with Delaware Investments to ensure the transition was successful.

Ensuring that the lift-out employees were effectively integrated into the BNY Mellon culture required a focused team of human resources members from both Delaware Investments and BNY Mellon. The co-sponsored team developed an employee integration plan and was particularly sensitive to the uncertainty that many of the lift-out employees might experience when undergoing such a change. Key components of the plan included:

- A provision that BNY Mellon would support the employees in their current work environment by leasing the Delaware Investments' office space in Philadelphia, Pennsylvania
- Assigning lift-out employees critical roles on the integration project
- Discipline-specific work streams (e.g., legal, HR, technology) leads who frequently communicated to employees during the transition
- Dedicated HR recruiter and generalist to focus on reducing turnover
- Careful review and decision making regarding benefits changeover from Delaware to BNY Mellon

The avoidance of long-term costs is another benefit of outsourcing by enabling asset management firms to move from a fixed cost structure to one that is variable, yet predictable.

The continued employment for the Delaware Investments' staff is of particular interest to Japanese asset management firms as it demonstrates how an outsourcing arrangement could be structured to take into account Japanese labor traditions. The clearly defined roles of human resources in the arrangement and commitment to ensuring a transition in which there were several advantage-oriented scenarios benefiting the lift-out employees were critical success factors. Accommodating Japanese asset management firms can be achieved by outsourcing to an experienced outsourcing provider that will work with the asset management firm to ensure that differences in corporate cultures and employee retention challenges are well understood and incorporated into the overall transition and integration strategy.

Formation of a Strategic Relationship That Allows Flexible Business Expansion

The Delaware Investments-BNY Mellon outsourcing agreement brought forth the formation of a strong relationship that allowed for Delaware Investments to experience future growth opportunities in a flexible manner. Prior to the outsourcing deal, the two firms had a longstanding business relationship whereby BNY Mellon provided custody services to the asset manager. However, when Delaware Investments outsourced its middle- and back-office operations to BNY Mellon, the relationship became even deeper as BNY Mellon integrated with Delaware Investments' daily operations component. As part of the agreement, Delaware Investments has positioned BNY Mellon as its value-added provider to assist Delaware with its business expansion. As a result, BNY Mellon has taken on some of Delaware Investments' offshore funds businesses that had been supported both locally within the market and via the infrastructure at Delaware Investments for portfolio management.

Cost Avoidance for Ongoing Technology, Training and System Development

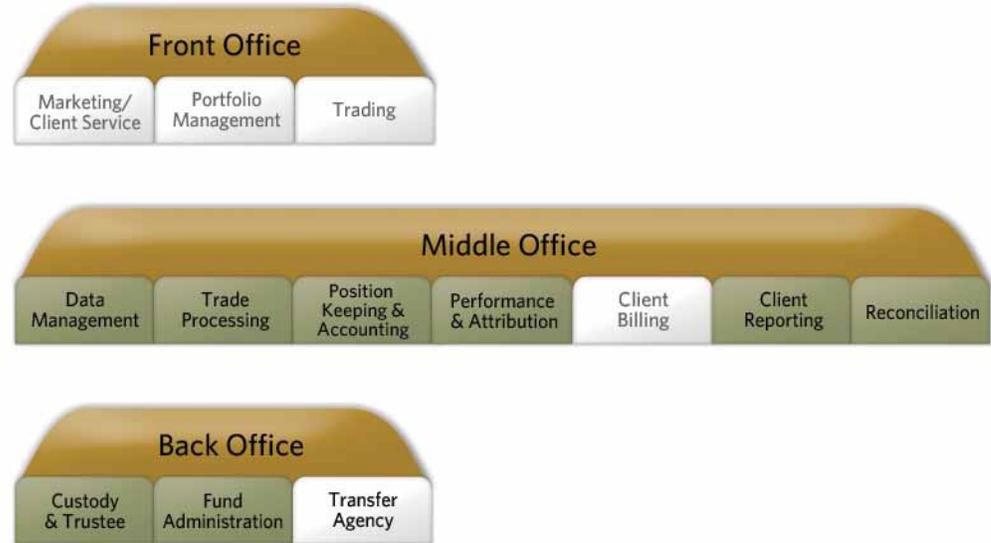
For Delaware Investments, its decision to outsource to BNY Mellon was not primarily about cost savings, but more about cost avoidance. Had Delaware Investments installed a new platform in-house, it would have required a significant technology investment and a highly skilled workforce to support it. And in addition to conversion costs, Delaware Investments would have also faced ongoing IT expenses such as software licensing fees, maintenance and upgrades; investment in hardware to support the new platform and business growth; training of employees to utilize the new platform, and continued investment to meet continually evolving regulatory requirements. The avoidance of long-term costs, in addition to the outsourcing arrangement allowed Delaware Investments to move from a fixed cost structure to one that was variable, yet predictable. The ability to enter a variable cost from a fixed one permits a level of flexibility for Delaware Investments in terms of business management.

Mitigation of Business and Operational Risks

The outsourcing deal between Delaware Investments and BNY Mellon enabled Delaware to maintain internal control of business and operational risks. Middle- and back-office operations were supported by the leading-edge technology of Eagle Investment Systems, a subsidiary of BNY Mellon. A major component of this offering is the ability to provide T+0 and T+1 valuation for Delaware Investments' accounts on a single accounting system, allowing for operations to be managed more efficiently than having separate systems. The Eagle technology can support middle-office operations such as GIPS and security-level performance, trade settlement, accounts payable and Schedule D reporting (insurance), which were key services of the outsourcing agreement with Delaware.

Delaware Investments was able to avoid the risk inherent in undertaking a major system conversion as it was able to leverage the expertise of a provider, BNY Mellon, with deep conversion experience. Also, a strong operational risk management environment was developed by establishing a strong governance model to oversee the operations performed at BNY Mellon. More than 200 service level agreements (SLAs) were created between Delaware Investments and BNY Mellon, which provided Delaware Investments with greater operational control and more transparency into the performance of the operations supporting its business.

Figure 1: Delaware Investments' Operations Outsourced to BNY Mellon



Outsourced services provided by BNY Mellon to Delaware Investments are depicted in green.

Implementation of the Solution

From the well-organized approach to the conversion and sequencing to a formal sign-off process, BNY Mellon and Delaware Investments developed a detailed implementation plan and co-managed strategy to manage the lift out and operational components of the outsourcing arrangement, including:

- A steering committee and core senior management team to address key issues and to offer timely decision making and leadership
- A dedicated conversion team to ensure sufficient operations testing time, detailed issue tracking, escalation procedures and resolution processes
- A business implementation team focused only on Delaware Investments to develop and document a new business operating model and control environment
- A dedicated project team and key liaison supporting the Eagle technology migration
- A team of internal resources providing training on new systems and new processes and controls
- A systems support team within the business

One of the unique requirements of this outsourcing case was that the solution fit within Delaware's current operating model, leveraging the existing Eagle technology solution. One of the significant benefits to deploying the Eagle platform was that it was able to support Delaware Investments' mutual fund, institutional and insurance accounts (T+0 and T+1 valuation) on a single platform. Competitive models typically involved multiple accounting systems to support multiple lines of business. The requirements to support Delaware Investments' business included: support of all security types, multi-class/multi-sector accounting, trade-date based reporting and feeds to downstream systems, daily security and account level GIPS performance, daily NAV performance, and transmissions to numerous business partners. In order to support the new operating environment, more than 100 inbound and 95 outbound data interfaces were built. For institutional accounts, more than 50 custodian and 35 investment manager and sub-advisor interfaces were created.

Management of Operations Outsourced to BNY Mellon

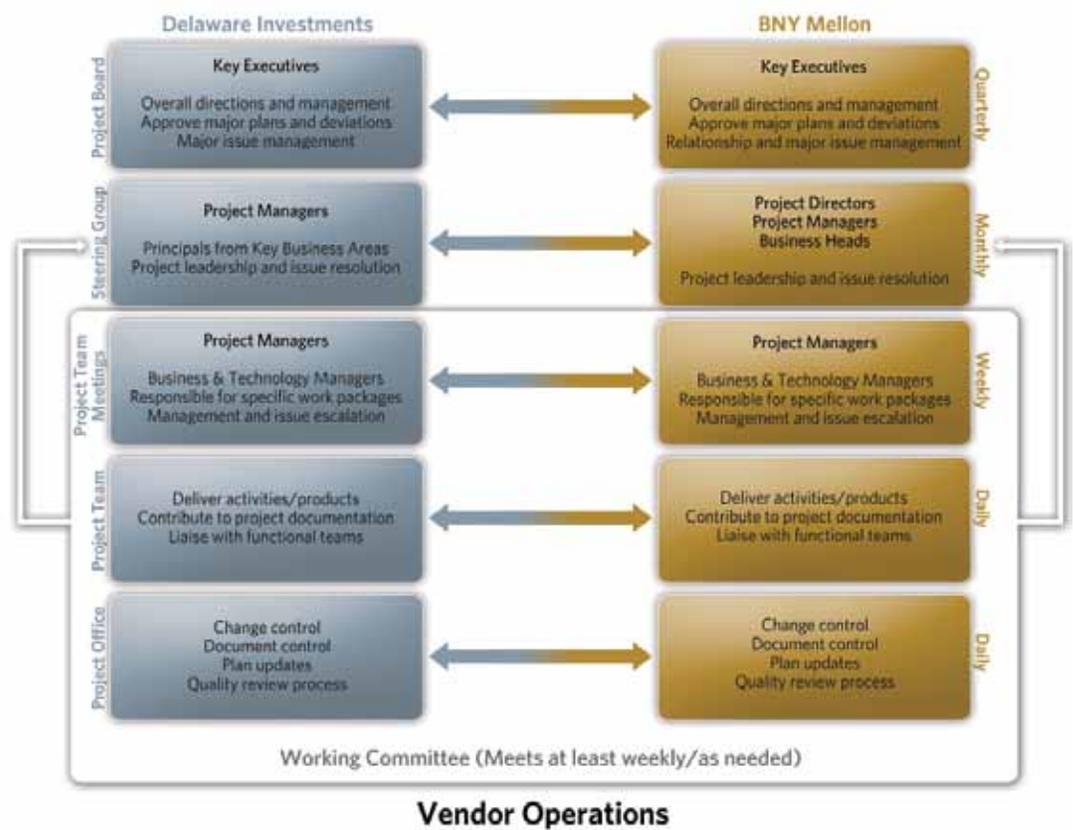
Throughout the entire outsourcing deal process, Delaware Investments was determined not to replicate the activities performed by BNY Mellon via a shadow accounting process. Shadow accounting often represents simply replicating the activities that the service provider is already performing. Approximately 15 people from Delaware Investments were assigned as a stay-back team with their main responsibilities focused on value-added analysis of the BNY Mellon operating results and proactive support of the front office. The stay-back team was split into three areas: Fund Administration, Fund Accounting, and Institutional Accounting. This calculated approach is important for Japanese asset management firms as it provides further assurances and a measureable plan for the lift-out arrangement. Further, it provides the ability to leverage the client-specific intellectual capital of the asset management firm.

The stay-back Fund Administration team at Delaware Investments was primarily responsible for financial reporting and fair value pricing. The accounting teams performed the majority of the oversight functionality by reviewing NAV calculations, trade and cash exceptions, yield analysis, expenses, and general ledger postings. All teams were responsible for providing research and support for resolution of items escalated by BNY Mellon. Delaware Investments periodically sample tested some of the funds' accounting operations completed by BNY Mellon and performed the majority of the oversight by obtaining detailed management reports on a monthly basis. These reports outline the status of all operations performed at BNY Mellon based on the SLAs and multiple key performance indicators that are in place between the two firms. The creation of the SLAs between Delaware Investments and BNY Mellon was a significant part of the project, which took considerable time as it became a key component of the ongoing performance expectations of the outsourcing relationship. Due to the SLAs in place, Delaware Investments has more transparency into the performance of the operations supporting its business.

NAV Calculations By Japanese Asset Managers Based on the Industry Standard

A Japanese asset manager is required to produce the NAVs for all of its mutual funds, as well as receive them from the trust banks it uses to custody the assets. After the NAVs are produced by the separate entities, reconciliation takes place to assure that the NAVs match. As such, the reconciliation of NAVs between the asset manager and trust bank could be labeled as shadow accounting. While it is not requirement stated by Japanese financial regulations, the practice of calculating NAVs twice is considered industry norm in Japan, for a country that is generally quite conservative in terms of its asset management business. Many asset managers perform their NAV calculations in-house rather than outsourcing it to a third party. Some industry experts have stated that if asset managers in Japan were not pressured to perform NAV operations the way they are currently performed, and there were clearly defined monitoring models, the result would be wider acceptance of the outsourcing proposition as a whole in the near future.

Figure 2: Governance Model for Delaware Investments and BNY Mellon



Source: BNY Mellon

Conclusions and Considerations for Outsourcing Firms Providing Services to Japanese Asset Management Firms

Japanese asset management firms seeking an outsourcing arrangement as an opportunity to build their businesses, focus on their core competencies and reduce fixed operational costs have two proven models for consideration: a 'lift-out' arrangement or a 'co-sourcing' arrangement. In particular, the costs of running middle- and back-offices at Japanese asset management firms are expensive and therefore the realization of turning fixed operational costs to variable costs is of high importance when considering outsourcing. Well established Japanese asset management firms would trend toward lift outs, while newer market entrants or those firms with the flexibility to do so would engage in a co-sourcing arrangement. In BNY Mellon's co-sourcing arrangements the firm takes a consultative approach to outsourcing that combines professional expertise and strategic insight with best-of-breed technology that leverages the experience and capabilities of its affiliate Eagle Investment Systems.

The Delaware Investments case study demonstrates the ability of an experienced outsourcing provider to perform a successful lift out that would satisfy Japanese labor traditions. In addition to conducting interviews with Delaware Investments, Nomura Research Institute met with several Japanese asset managers who have also stated that if they were to outsource many of their operations, they would keep in-house some operations considered as value added services such as performance analytics and client reporting. As expressed by Delaware Investments, these operations often require frequent interaction with front-office personnel and/or external parties and are performed by highly skilled staff with a concrete understanding of the portfolios managed by the firm.

From Nomura Research Institute's perspective, the interest in outsourcing has arguably gained a further stronghold in the minds of many asset managers globally as they are now re-evaluating their overall business strategy. This includes ways to reduce fixed costs and transition to variable costs. The benefits of an asset manager outsourcing its operations are not just simply to off-load their operations to a reputable service provider, but also to have a trusted relationship so that the asset manager can offer high level services to its investors during both favorable and unfavorable markets. Other important considerations include the ability to provide T+0 and T+1 valuation for asset management firm accounts on a single accounting system. As evident in the Delaware Investments-BNY Mellon outsourcing case, Delaware Investments recognizes BNY Mellon supporting its operations backbone, enabling Delaware to focus on its core competencies and grow its business.

Structuring the business relationship in a way that results in a collaborative approach with core transition teams, work streams, and defined operational and business processes is essential to a successful outsourcing arrangement. Nomura Research Institute believes that the flexibility of outsourcing service providers to embrace custom labor traditions holds much promise for Japanese asset management firms, both for well-established firms and newer entrants into the market.

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About BNY Mellon

BNY Mellon is a global financial services company focused on helping clients manage and service their financial assets, operating in 36 countries and serving more than 100 markets. BNY Mellon is a leading provider of financial services for institutions, corporations and high-net-worth individuals, offering superior investment management and investment services through a worldwide client-focused team. It has \$25.8 trillion in assets under custody and administration and \$1.26 trillion in assets under management, services \$11.8 trillion in outstanding debt and processes global payments averaging \$1.5 trillion per day. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. Additional information is available at www.bnymellon.com and through [Twitter@bnymellon](https://twitter.com/bnymellon).

About NRI

Nomura Research Institute, Ltd. ("NRI", TYO: 4307) is an independent, global IT solutions and consulting services provider with annual sales of 335.5 billion yen as of FY ended March 2012. With front-to-back support for the buy- and sell-side, NRI's tradition of innovation has positioned them as a trusted international market leader. Leveraging NRI's global consulting business, NRI is able to provide innovative financial IT solutions for investment banks, asset managers, banks and insurance providers. For more information, visit www.nri.com.

About Delaware Investments

Delaware Investments manages more than \$165 billion in assets under management (as of Dec. 31, 2011) with 138 portfolio managers, analysts, and traders.

Delaware Investments provides world-class asset management services and solutions for institutions and individuals. Today's Delaware Investments is more dynamic than ever before, managing assets across all major asset classes for a wide range of investors.

Products and asset management services include:

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- Corporate and public retirement plans
- Endowments and foundations
- Taft-Hartley plans
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