



Financial Risk Solutions

Knowledge based software

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Research Update

October 2014

Asset Manager Oversight
of Service Providers

Overview

With the increasing trend amongst asset managers to outsource non-core functions to third party service providers, effective oversight and supervision by asset managers of the outsourcing service provider's operations is coming under increasing regulatory focus in an era of record regulatory fines. New tools are required to assist oversight professionals in carrying out this key function. In this research update, George McCutcheon examines this issue in more detail.

Key Messages for Asset Managers

- Asset managers will need to invest more in technology solutions for supervision of their service providers
- New technology tools are required to improve the transparency between asset managers and service providers
- The FCA require that asset managers have the required GRC (Governance, Risk & Compliance) expertise in place to oversee critical outsourced activities.
- The GRC function needs to be empowered through the provision of appropriate tools for oversight and for risk and performance analytics
- In order to meet regulatory requirements of SYSC 8 of the FCA Handbook that the firm (and its auditors) have effective access to data related to the outsourced activities, asset managers and their risk management and compliance functions will require access to asset data. Ideally this should be via a web reporting layer providing real-time unfettered access to asset data.

Background

Outsourcing with risk based oversight has emerged as an industry trend but with emerging regulatory push-back on this suggesting a greater level of shadowing of certain outsourced processes.

Asset managers are increasing their reliance on outsourced services in an environment of growing demands from regulators and clients, heightened competition and a need to best position their firms for future growth. This shift in operating model is exposing managers to a broader array of risks that require more effective risk management.

Following on from the 'Dear CEO letter'¹ to asset managers and the FCA thematic review TR13/10 on outsourcing in the asset management industry, the industry response was the OWG Report².



¹Referring to the outsourcing of regulated activities and/or activities that are "critical or important" in the support of regulated activities as set out in SYSC 8.1.4R.

²The OWG was an outsourcing working group comprising the Investment Management Association, several asset managers and key service providers. In December 2013, the OWG published practical measures for asset managers to improve the oversight and resilience of their outsourcing arrangements. The review considered middle office outsourcing, including fund administration and transfer agency functions.



FCA Thematic Review

The FCA carried out the review because it was unsure whether asset managers subject to SYSC 8³ were effectively managing the risks associated with outsourcing to ensure that customers are not adversely affected. The FCA assessed whether asset managers were complying with SYSC 8, by having:

- adequate contingency plans in place for the failure of their service provider
- effective oversight of their service provider(s)

Action plans for Asset Managers

- Following TR13/10, the FCA is expecting that asset managers review their own outsourcing arrangements and assess the effectiveness of their oversight arrangements to oversee critical activities outsourced to a service provider
- The OWG have suggested that firms review their outsource arrangements in the light of the guiding principles and considerations of the OWG report

Practical application plans for Asset Managers

- Benchmark current outsourcing oversight policies and procedures against expectations and guidance contained within SYSC8, Thematic Review TR13/10, and the OWG Report
- Implement improvements to oversight capabilities
- Document oversight policies and procedures

³SYSC 8 Outsourcing under Senior Management Arrangements, Systems and Controls sourcebook under High Level Standards

Regulatory Requirements

The FCA rules on outsourcing are in SYSC 8 of the FCA Handbook and closely follow the MIFID Regulations.

- A firm that outsources critical or important operational functions remains fully responsible for discharging all of its obligations under the regulatory system
- The outsourcing must not result in the delegation by senior personnel of their responsibility.

Establish methods for assessing the standard of performance of the service provider

- A firm must establish methods for assessing the standard of performance of the service provider
- A firm must ensure that it takes reasonable steps to avoid undue additional operational risk when relying on a third party for the performance of operational functions which are critical for the performance of regulated activities

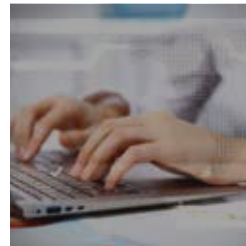
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- Firms must be able to terminate the arrangement for the outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients
- Firms and the service provider must establish, implement and maintain a contingency plan for disaster recovery and periodic testing of backup facilities where that is necessary having regard to the function, service or activity that has been outsourced.

The firm, must have effective access to data related to the outsourced activities

- The firm, its auditors, the appropriate regulator and any other relevant competent authority must have effective access to data related to the outsourced activities, as well as to the business premises of the service provider; and the appropriate regulator and any other relevant competent authority must be able to exercise those rights of access



Giving Effect to Regulatory Requirements

The problem for asset managers is how best to give effect to the regulatory requirements in a cost effective and efficient manner.

A key assumption made by the OWG was that oversight procedures should not require the asset manager to replicate outsourced functions (e.g. maintaining dual records) as that was considered to negate the efficiencies gained by outsourcing. Whilst agreeing with the principle of the single source of truth, much more can be done with that single dataset. Technology tools are required to improve the transparency between asset and service provider.

The solution is to leverage the data of the service provider and to deploy an oversight technology solution based on efficient data transfer processes.

Supervising service providers involves establishing a control system, at the heart of which is a set of objectives and a process to monitor if these objectives are being achieved. Overlaid on this should be a mechanism for sensing environment changes which might require the objectives to be recalibrated.

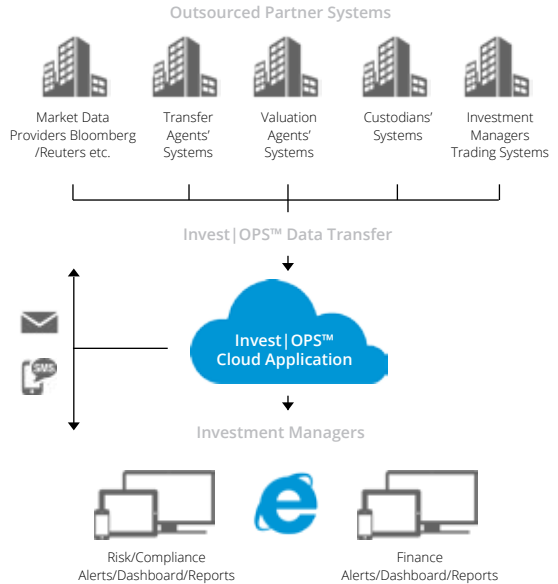
All of this is crucial if the outsourcing process is to deliver transparency, efficiency and control. Transparency is provided through data visualisation layers with advanced data filtering, sorting, paging and user configurability displaying data through a wide range of interactive display options. Customised dashboards provide oversight staff with views of the data they require and in the format that they require complemented by exceptions and breach reporting.

Advantages of approach

A single source of truth for asset data

- Establishes methods for assessing standard of performance of service provider through risk and performance metrics
- Empowers the asset manager's oversight function through customised dashboards, compliance reports, email alerts, data analytics, risk metrics
- Allows the asset manager to supervise the service provider and to manage the risks associated with outsourcing
- Provides the asset manager with effective access to data
- Reduces the operational risk associated with outsourcing
- Provides a daily monitoring system

Invest|OPS™ – Outsourced Partner Supervision



Keys to successful oversight

- Risk based approach
- Technology
- Utilise skilled professionals
- Establish acceptable performance metrics for the service provider
- Risk mitigation plans
- Accountability
- Commitment
- Daily oversight

Asset managers must be fully committed to the oversight process to ensure its success. The optimum level of oversight can be achieved by prioritising the high risk activities and outputs as part of the overall evaluation of the outsourced processes.

There are a number of methods to monitor service providers e.g. exception reports; KPIs, KRIs, oversight policies and procedures, dashboards, checklists, review meetings, oversight job descriptions but a core requirement is to have the appropriate technology to empower the oversight professionals. Appropriate levels of risk based oversight can be maintained by knowledgeable personnel experienced in analytical review but this needs to be complemented by technology tools providing data analytics and performance and risk metrics and online access to data. The monitoring of environmental factors is an important part of the oversight function as key risk items such as turnover of service provider staff, key person risk, frequency of error, processing timescales can be monitored through risk metrics.

Asset managers should ensure that risk management processes include triggers to escalate oversight and monitoring when service providers are failing to meet performance, compliance, control, or viability expectations.

OWG Report

The 'Guiding Principles' for oversight are:

- Know Your Outsourcing (KYO) - Building a full understanding of the scope, nature, locations and contractual terms of their outsourcing arrangements in order to effectively manage and oversee the relationship with their service provider
- Risk-based Assessment - Conducting a risk-based assessment of outsourcing arrangements to understand the impact on the firm and the end client
- Ownership - Establishing an appropriate level of ownership at a senior level for the outsourced activities reflecting the size, nature and scale of the firm and the activities outsourced

Key Oversight Recommendations (Live Environment) of OWG Report

- Perform on-going monitoring at appropriate frequencies and retain supporting evidence
- Ensure appropriate engagement and ownership from operations and control functions (Audit, Risk and Compliance)
- Assess, escalate and resolve errors, service exceptions and control failures



Issues for Asset Managers (arising from OWG Report)

Key questions arising for asset manager are:

- What is the appropriate frequency for service provider supervision and monitoring?
- To what extent does it need to independently verify that their outsourcers are providing the contracted service
- What tools are required to assist the oversight function?

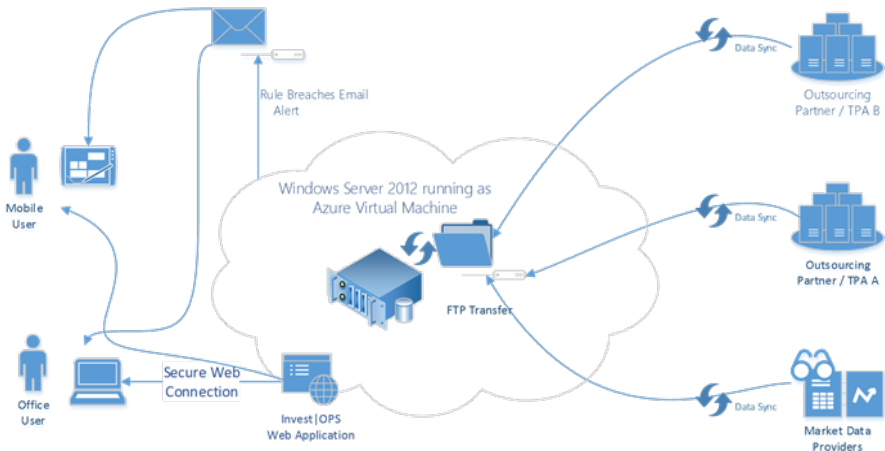
Daily outsourced partner supervision will become the de facto solution expected by regulators and this will necessitate the deployment of new tools by asset managers.

What technology solutions are required?

Oversight capability will require browser based solutions with the capability to either look-through into the primary investment system or to deploy oversight tools that operate based on data pumps from the primary investment system and from market vendor data sources.

How can the asset manager ensure that the service provider is providing the contracted services?

- **Producing correct NAVs**
- **Adequate systems and controls**



The strategic reasons for outsourcing in an environment of increasing regulation include the need to update supporting technology systems and to reduce costs. However outsourcing can fail to meet its strategic objectives if value in terms of cost reduction, increased innovation and improved flexibility are negated by the greater need for monitoring, auditing and issue management. That is where effective oversight technology can make the crucial difference and avoid potential conflicts between asset manager and service provider which would otherwise result in strained relationships between the parties.

FRS have such an oversight offering called Invest|OPS™ (Outsourced Partner Supervision) which we would be happy to discuss further if this is appropriate, feel free to email frank.carr@frsLtd.com to discuss this further.

Biography; George McCutcheon MSc FIA:

Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS). He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland.

About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund administration software to the life assurance and pensions industries. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund administration area and customers in life assurance and third party administration include MetLife, SEB, IFDS Percana, and Accenture Managed Services.

Invest|Pro™ manages unit pricing and portfolio valuations, asset/liability unit matching, box management, trade order management, investment accounting, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions, shareholder funds and with-profit funds. Invest Pro™ was specifically designed to securely automate complex fund administration processes.

Invest|OPS™ (Outsourcing Partner Supervision) automates the validation of operational activity performed by outsourcing partners. It provides methods for assessing the standard of performance of the service provider; enables the investment firm to supervise the outsourced functions and to manage the risks associated with outsourcing. It also provides the firm with effective access to the data associated with the outsourced activities.

Invest|GRC™ provides visibility of aggregate asset positions and other relevant compliance and risk management data. Invest|GRC™'s Data|Pump server application is used to populate and synchronise the Invest|GRC™ data warehouse with data from the company's investment systems and from external market data providers.



Knowledge based solutions

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