

# Moving out

**Hermes took a new approach to choosing an outsourcer in a bid to cut down on time and find the right cultural fit. Philip Keeler tells Nick Fitzpatrick how it worked and why the firm moved functions out-house**

When Philip Keeler, operations & IT director at Hermes, the fund management firm owned by the British Telecom Pension Scheme, embarked on an outsourcing project he was sceptical about the process that asset managers use to appoint their providers.

Hermes had decided to outsource certain functions to support its growth plans that included hedge fund launches and a deeper push into the third-party investment management business.

Faced with the thought of sifting through proposals from outsourcers, which several years of working on the provider side at a large custodian had told him were largely sales pitches under a different name, Keeler and his team wanted to do things differently.

“Most provider selection processes go through formal RFI and RFPs [request for information/proposal], which require a lot of sales effort by providers and provides little real information to the prospective client. So we took a different approach,” says Keeler.

Hermes, which manages £24.6bn (€28.8bn) of assets, created an information pack that set out a clear description of the firm’s products, assets and requirements. This was then used as the basis for workshops where candidate providers presented their solutions.

“We did this, first, because we wanted to progress quickly, and second, to establish a good cultural fit by working with the management and staff of the provider.”

The cultural fit is important because “you need to be sure that the provider is one that you feel comfortable working with on a long-term basis through out the life of a contract and beyond”, says Keeler.

The search started mid-December 2007 with a long-list of six outsourcers. The shortlist of two

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was ready by the end of February 2008 and Hermes had selected Northern Trust by May. Another manager’s process that started at around the same time took 18 months, says Keeler.

Hermes is now close to completing the migration of its back office and fund administration functions for core products to Northern Trust. Hermes also uses other specialist providers such as Société Générale Securities Services, Goldman Sachs, RBC Dexia and IFS.

Performance measurement and performance attribution is also being outsourced for portfolios where possible, as the data required for these services is closely aligned to the back-office data that is also outsourced.

Additionally, hosted solutions are employed where an outsourcing arrangement is not available. Providers include Algo Risk, a risk management provider, and MRI Software for Hermes’ real estate activity.

Keeler says hosted solutions reduce the implementation costs of outsourcing as well as ongoing operational costs.

But he adds: “Many senior managers in asset management still look at outsourcing as a way

of reducing costs, but I think it is easy to demonstrate that outsourcing should not be driven by cost alone.

“The decision to outsource has to be a board decision driven by strategic considerations regarding a company’s core business as well as cost.

“You have to keep in mind that the outsourcing provider has to make a reasonable margin on the revenues to justify their operational risks involved. This margin needs to come from achieving operational efficiencies.”

Providers themselves may have to make further efficiency savings to help fund managers realise theirs. These savings could come from migrating fund managers to a strategic platform, but this is complex and both parties will incur significant upfront project costs that have to be written off or depreciated.

“The provider will also be concerned that the costs are incurred before any revenues arise from the contract and this can impact earnings,” says Keeler.

Also, fund managers have to retain an element of the original operational costs for staff needed to provide oversight of providers through the middle office, Keeler adds.

“To enable cost savings through outsourcing the provider will need to be able to reduce the fund manager’s original operations and IT costs by around 50% to make the deal viable, which is quite a challenge.”

## **Scaleable and robust**

To pinpoint where outsourcing would be beneficial the operations team at Hermes carried out strengths-and-weaknesses tests in each business area to see where new systems were needed and where threats to the business lay. This review wasn’t just focused on

Philip Keeler, Hermes



operations, but on the whole business from the front office to the back.

“We then worked with senior management to develop an operating model that would carry the business forward and this included specifying which components could be outsourced,” Keeler says.

Outsourcing was recognised as the most scaleable and robust option to meet business needs in a timely way.

“Hermes is like many investment businesses in that it is becoming more complex in terms of both product and instruments. The time to market for new products or new instruments can be lengthy if the current systems cannot support them.

“OTC derivatives are an example where all areas of our business have complex and

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dynamic requirements. If we had decided to implement a full derivatives system in-house then this would have been a very, very big budget item but we only use a fairly small number of derivative positions at any time. The staff costs to implement, develop and operate this type of system are expensive.”

Consultants Investit and Morse assisted the process.

As well as the cultural fit, other key selection criteria included the level of strategic alignment between Hermes with Northern Trust, the quality of the people, and the development of the provider’s global operating model.

“When we looked for our provider we wanted to see a clear understanding of their operational strategy. Did they have a clear, single operating model and have they shown capital commitment to invest in it over the last five years? This indicates whether they are serious about this business area.

“You tend to find specialist platforms for derivatives, fund administration and custody. The question is, are they integrated into one model and have all clients migrated to the strategic solution? Some providers that have executed lift-outs in the past are still trying to migrate clients to the strategic solution.”

Hermes was also mindful of consolidation in the investor services industry when it selected its outsourcer.

“There are still too many providers in the market so there is likely to be further consolidation among them. It is therefore important to make sure that the selected provider is going to be a long-term player in this market. It is useful to review how significant asset servicing revenues are for the provider from both a strategic investment aspect and whether the provider may be acquired due to the attraction of other product areas. This is more important than its absolute size of the business.”

Once the physical process of outsourcing began, custody migrated first and then fund administration and fund of hedge funds administration followed. Trade processing also went and Hermes is now building up to outsource main back-office functions covering dividends and corporate actions processing, reconciliations, valuations and investment accounting.

Keeler believes outsourcing is of growing interest to fund managers.

“I believe more people are looking at outsourcing now because of pressures on their business, such as revenue pressure and margin pressure. If a company has a limited projects budget then there is pressure to invest this in the added value areas of the business instead that add to revenues rather than investing in the back-office systems, so outsourcing the back office becomes attractive.”