Efficient fund operations
Decision making for a leaner future

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Geoff Hodge, CEO of Milestone Group, examines the role and impact of investment decisions on achieving effective operating models and technology architectures at financial services institutions. He explores the practical aspects and pitfalls of decision making, and how this can dictate a firm’s long-term agility, efficiency, scalability and profitability.

More often than not, technology plays a significant role in transformation initiatives aimed at sustained profitability and the related objectives of cost and risk reduction, enhanced client service and product innovation. Investment decisions are typically made on an incremental basis, taking into account an investment horizon that assesses returns over a five year period. However, the need to support new products, meet additional regulatory requirements, improve transparency or respond to other unanticipated events, means that technology investment and transformation costs can spike at any point along that anticipated payback timeline. These unexpected costs, or an equivalent ‘shock’ to expected revenue, can derail projects and negate anticipated efficiency benefits. In severe cases, such unexpected events can directly contribute to impaired business performance and eventual business failure.

This paper looks at the inherent dangers in the technology investment cycle and decision-making process as they apply to the fund administration industry. It suggests alternative investment criteria that deliver optimal efficiency results. The paper looks specifically at the impact of product maturity, the consequences of changing circumstances on short-term investment planning horizons, and the need for long-term visualisation of a desired end-state for businesses wishing to create an efficient, sustainable and competitive fund administration operation.

Are we already efficient?
At a macro level, most market practitioners agree that there is some compelling evidence that operational processes supporting funds servicing are yet to reach an optimal level of efficiency. This is backed up in both current operating costs scale curves and in behaviour around offshoring.

Scalability is a term that is often misused in fund administration to refer to the ability of an organisation, process, or system to deal with significant volumes. A more useful definition of scalability incorporates the concept of a predictable and diminishing average unit cost as business volumes increase. This disparity between volume and genuine scalability has been evident historically in outsourcing deals where a ‘lift out’ occurs and efficiencies are contractually underwritten by large balance sheets well ahead of
being delivered by truly scalable infrastructure in terms of labour utilisation.

Offshoring is a direct response to the high labour cost and volume-sensitive nature of labour within fund administration and this contrasts sharply with the highly scalable custody market where large volumes of incremental business can be added with little or no impact to labour usage.

The current focus on the offshoring of fund administration activities is a form of labour market arbitrage and seeks to reduce total labour cost. This approach often uses the same amount, or even more labour, but at a lower unit cost. Off-shoring is often burdened with the need to trade off savings with higher management overheads to contain operational and client service risk, higher rates of staff churn and rising offshore labour costs as globalisation continues.

The real problem with too much focus on offshoring is that it can actually mask a lack of genuine progress in making the underlying operating model more efficient, which can be detrimental to longer term innovation and competitiveness. So why is it that the global funds industry has struggled to achieve meaningful efficiency gains in fund administration?

Why is the funds product lifecycle demanding more efficiency now?

Industry and fund product life cycles play a key role in understanding the demand for increased efficiency and operational capability. It is common to look at specific events, such as the global financial crisis, as catalysts for change, but macro effects are also driving a more fundamental shake up.

We should expect that the mature product phase of the funds industry will demand a level of efficiency that challenges some of the widely accepted business metrics, operating approaches and supporting technology capabilities that have been seen as acceptable up until this point.

Typically, new areas within financial services evolve through a period of heavy product development and marketing focus characterised by rapid growth and wide margins. Technical considerations and product knowledge consume management agendas and operational efficiency is often a distant priority.

As shown in Figure 1 below, as products mature and margins come under increasing pressure, attention shifts initially to process management and then finally to the core skill set of production management – namely, efficient use of resources,

<table>
<thead>
<tr>
<th>New Product</th>
<th>Maturing Product</th>
<th>Mature Product</th>
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<tbody>
<tr>
<td>Product focus</td>
<td>Process focus</td>
<td>Production management focus</td>
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<tr>
<td>Low volume</td>
<td>Growing volume</td>
<td>Higher volumes</td>
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<tr>
<td>High margin</td>
<td>Moderated margin</td>
<td>Margin pressure</td>
</tr>
<tr>
<td>Technical knowledge is ‘king’</td>
<td>Process knowledge is ‘king’</td>
<td>Unit cost/efficiency is ‘king’</td>
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the elimination of non value-added activities and real process automation. At this point, the latter become necessary for new and sustainable levels of operational efficiency to be achieved.

In most developed markets, fund products and their servicing requirements have entered the mature phase of the product lifecycle. Therefore the majority of decisions to invest in improvements to, or replacements of, operating infrastructure and related technology are motivated by a perceived opportunity or need to dramatically improve operational efficiency. This has been exacerbated by the fact that recently, commercial objectives have been placed under pressure by a combination of market and competitive shocks and stresses, which has led to an even greater need for aggressive and radical efficiency improvements.

Put simply, margin pressure is a characteristic of a maturing market, and it is often the real macro level catalyst for marshalling organisational and industry attention to the subject of driving deep-seated change in operational efficiency.

**Investment time horizon**

Investment time horizons refer to the period over which costs associated with an investment project are compared to the benefits that will accrue over the same period. Firms typically consider a baseline five year investment horizon as representative of the useful life of the solution. It is not uncommon to also have a target payback period that is shorter than this, which may even be aligned with a single budget cycle.

While this approach is well suited to opportunities for incremental change, it seems fundamentally inconsistent with strategic decisions where technology choices often remain in production for 15 to 20 years.

Off-shoring is often burdened with the need to trade off benefits against higher management overheads to contain operational and client service risk, higher rates of staff churn and rising offshore labour costs as globalisation continues.
So the question that needs to be considered is: How will the cost of ownership of a given solution behave outside of the typical five year window on which the specific decision was based?

To make this point, consider Figure 2 below which contrasts three candidate investment decisions that could be analysed, comparing costs and benefits over a five year period. For the purposes of this example, assume each investment yields a similar economic return with differential investment profiles (cost of ownership) as set out in Figure 2.

The curve represented by C1 is the lowest cost investment, C2 is a higher cost investment, and C3 is the highest cost project when amortised over a five year period. For a given set of business benefits depicted by B1, any typical financial analysis would systemically select C1 as the correct investment over a five year term.

Now consider the cost of ownership in year 10 when, as we have established, in all likelihood this solution may still be in operation. In C2 the net economic return is unchanged, under C3 the net economic return has increased, but under C1, the apparent optimum decision when considering a five year term, the cost of ownership has not only increased dramatically but has become cost prohibitive in operating the business without further change.

This phenomenon largely explains the challenges that the industry is currently facing when refreshing business architecture and supporting technologies where the useful life in the organisation has extended well beyond the initial time horizon contemplated. Frustration with current operating capability and associated levels of efficiency is compounded by the realisation that multiple solution components based upon these types of decisions are now well past their intended reset dates.
It is important to note that the original investment decision was not incorrect, based on the analysis undertaken. Rather, organisations have been busy growing and managing their businesses and have not diligently revisited each decision systematically at the anniversary of the original investment to consider the costs and operational capability implications of continuing beyond the original time period.

**Measurement of non-financial benefits**

‘Non-financial benefits’ is often an inaccurate label for benefits that may be difficult to measure or agree upon, but may be very substantial. Non-financial benefits are often disqualified from financial scrutiny and subordinated in decision making.

The original reason for this limiting practice was to ensure that investment decisions remain objective and to eliminate personal or ‘sponsor’ bias where costs may be understated or intangible benefits overstated. This can lead to a bias towards incremental shorter-term decisions, and substantial competitive value may be overlooked.

Today, the impact of this approach is becoming evident as organisations compete in a low margin climate. To exploit innovative efficiency opportunities fully, organisations now need to be able to better measure the value of non-financial items in their investment decisions.

Business drivers such as operational risk reduction, service enhancement, product time-to-market, and secondary or tertiary operational benefits are often noted as comments in business cases rather than being quantified and assessed as financial items. Examples include:

- Speed, agility and reduced operational risk arising from simplification of operating model and reduced inertia associated with change initiatives
• Elimination of unpaid overtime or losses directly attributable to operational stress arising from strained resource levels

• Displacement of low profile but high risk spreadsheets and related personal tools that present weaknesses and hidden labour costs

• Reduced risk and costs associated with change initiatives arising from simplified business architecture and reduced data movements, reconciliation and remediation overheads

• Value associated with how the investment positions the organisation to address related or future challenges more simply and cost effectively once the transformation initiative is complete

• Costs associated with time allocated to projects by business resources, where the organisation would incur these costs whether or not the project is undertaken

While no one disputes that non-financial benefits are key motivators and often represent the largest long term prize in transformation initiatives, they are often relegated, or expressly excluded, from financial analysis that underpins recommendations to investment committees or boards.

Assessment of strategic business impact
It is well understood that change is constant. It is becoming better understood that businesses also need to plan for more extreme scenarios that effectively stress test their business models against potential revenue shocks, such as an unanticipated change in market conditions or competitor behaviour.

It is implicit that investment committees considering investment proposals for business transformation need to look beyond the financial analysis
presented within an individual business case, and understand the context of how this initiative will strategically position the business under future operating scenarios that may include such shocks.

*Figures 3 and 4 below contrast a typical series of incremental investment decisions that are entirely logical under normal market assumptions, but can be shown to lead to total business failure in circumstances where these assumptions become invalid due to an unanticipated shock.*

*Figure 3* shows ‘normal’ trading conditions where margin pressure progressively causes revenue to decline for a given business volume through time. Normal profitability is maintained through a series of incremental investment decisions that improve efficiency at a relatively consistent rate over the same time period. These investment decisions are characterised by traditional financial analysis over a five year time horizon, and protect the business adequately in circumstances where there is no shock to normal trading conditions.

*Figure 4* depicts a situation where there is a more sudden shock to the revenue line, leading to a new revenue line (R2), which may be a consequence of an outbreak of a period of aggressive competition, or an external shock such as the global financial crisis. In this example, the revenue line shifts downwards over a short timeframe and creates a negative margin unless the cost curve (C1) can respond quickly.

Given the inertia associated with most operational business infrastructure and supporting technology, such a quick response is often difficult to achieve in a short time period, so the normal approach is to cut staffing levels. This may expose the business to increased risk levels or client dissatisfaction where service levels cannot be maintained. Clearly, this...
situation is not sustainable in the long term and different organisations will have different levels of endurance depending on their financial strength and beliefs. Figure 4 shows the very difficult situation faced by businesses that are unable to anticipate or quickly respond to such an event.

In reality, such events and related uncertainty have contributed to an increased focus on off-shoring and increased use of outsourcing initiatives as tactical responses where strategic change has not been possible within the timeframes required. As previously noted, these responses are not sustainable longer-term, without genuine technology enabled efficiency gains.

Preparing for a leaner future
The key to achieving sustainable operating efficiency is to ensure that investment in operational transformation will deliver a set of outcomes that enable the business to remain viable in a changed set of market conditions.

A more inventive and strategically superior approach is depicted in Figure 5, where strategic transformation is undertaken ahead of an anticipated shock. Most importantly, achieving this leaner model enables an organisation to absorb the impact of significant revenue pressures that may occur.

This model moves the organisation to the most efficient reasonable operating capability available (C2) irrespective of the level of certainty of a potential future shock to normal operating conditions. In this diagram, the shock event is again represented by the revenue line moving from R1 to R2.

The logic here is that if a revenue shock does occur, then the business is already positioned to remain profitable under those circumstances, and action was

![Figure 4: Aggressive competition or revenue shock](image-url)
taken at a time when the business was able to make the investment. The investment in operational transformation is often a necessary condition to help the business to remain viable in a changed set of market condition. Early action makes for a smoother transition. If the shock does not occur, then investment in moving to a lower cost operating model improves competitive positioning and generates enhanced profitability in the future.

In the absence of clear assessment of the strategic business impact, a perfectly logical series of incremental investment decisions (or projects) conducted using the common practice of business cases primarily based on a five year financial analysis, can systematically lead a business to a sub-optimal, or even business threatening operational outcome.

**Conclusion**

Investments must be viewed as a strategic cog in a larger machine that will move the business towards an improved end state. Against this backdrop it is clear that simple financial analysis over a traditional five year time horizon is limiting if the organisation seeks transformational change.

What has been discussed in this whitepaper is the emerging significance of the broader context of investment decision making to ensure that real value is not overlooked. More specifically:

- The need for operational transformation in fund administration has arrived globally and is being driven by funds product lifecycle, market conditions and competitive pressures

![Figure 5: Strategic business response](image-url)
• While offshoring, or other labour market arbitrage initiatives, are a legitimate component of an efficient operating model, they should not be confused with investment in genuine operational innovation

• There are hidden pitfalls and limitations in traditional decision making practices that can prevent true operational transformation

• Active consideration of the investment time horizon, strategic business impact and non-financial benefits can unlock greater strategic efficiency gains and increase long term profitability

The compelling idea that emerges from observing both the lived reality of an investment decision and the theoretical considerations behind it is that the current demand for transformational change in fund administration will be best served by a deeper and more flexible approach to analysis of costs and benefits associated with business cases.

It is the effective assessment of the strategic implications and opportunities embedded in investment decisions that will unlock a new level of efficiency that is often sought but frequently believed to be out of reach.

This is the first of three papers that will examine the role of operating model design and technology investment in achieving efficient fund administration. The whitepapers are intended to be read either as standalone documents or a series, and together will create a roadmap for those seeking a more competitive level of fund administration efficiency than is routinely observed today.

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Milestone Group is a global provider of investment technology solutions for fund oversight, fund processing, fund distribution, tax & accounting and investment analytics.

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