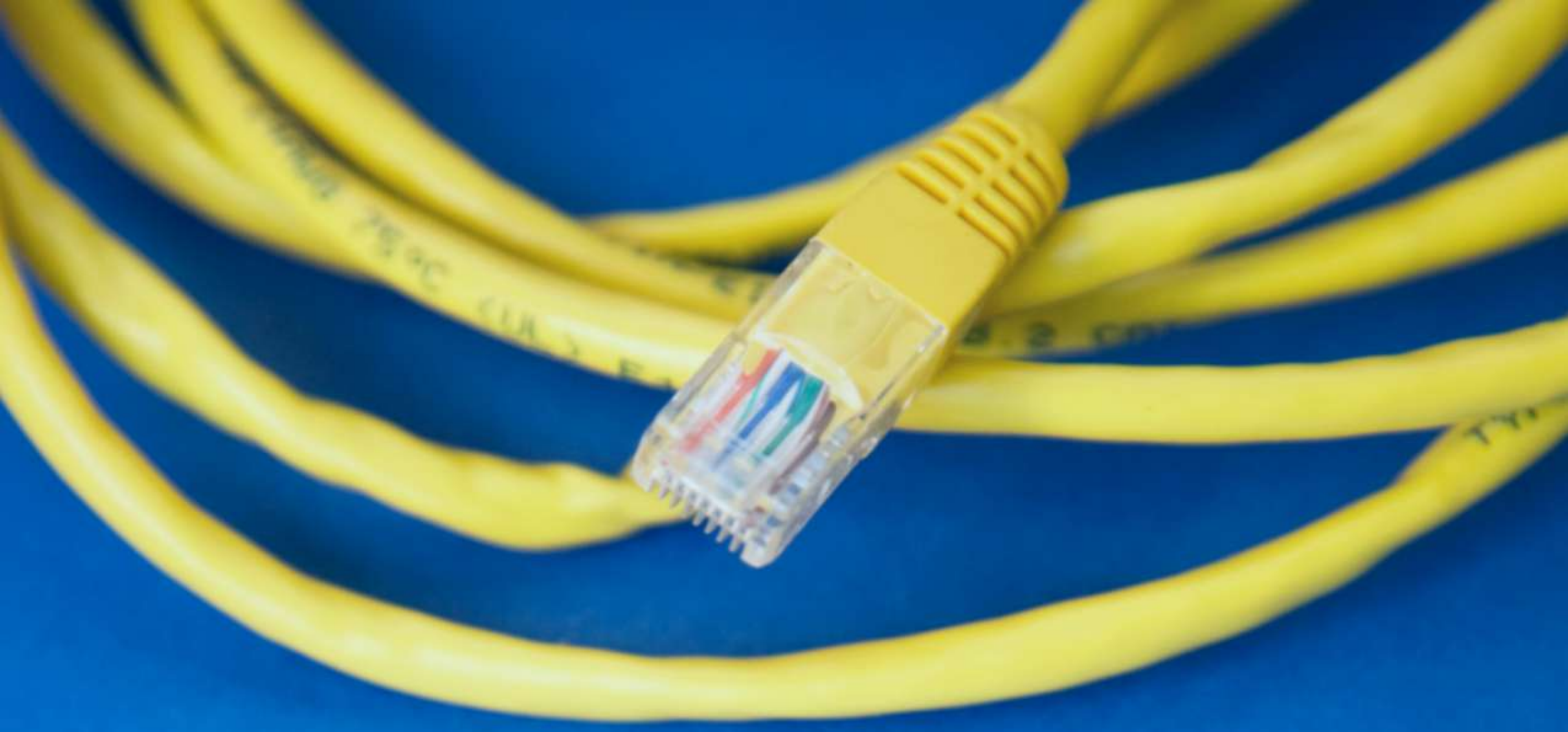

System Efficiency & Outsourcing in Wealth Management

December 2019

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Introduction

Currently less than 10% of costs in UK wealth management relate to outsourcing, placing it far behind other industries such as the institutional asset management sector, where it is common practice to outsource the majority of back office functions. Are wealth management firms therefore missing a trick and are in-house IT systems sufficiently efficient to cope with existing business and drive future growth?

With this in mind, Compeer worked in partnership with Global Prime Partners to ascertain the view from the firms themselves. This report outlines the results from 15 interviews with Chief Operation Officers at UK Wealth Management firms. The firms varied from smaller, relatively new firms, with others that have been established for many years and have therefore grown to be among the larger players in the industry. The assets managed and administered by these firms ranged from £2bn to £15bn.

There were three key themes throughout the interviews, which provided a deeper understanding of the current state of IT outsourcing:

- The business strategies of these firms and their future growth projections
- How they currently operate in the technology outsourcing space
- Understanding what makes a good outsourcing partner from the perspective of a wealth management firm

About GPP

GPP is a multiple award-winning financial services firm who provide integrated investment administration, execution and settlement and custody services to discretionary wealth managers, family offices, advisory firms and broker-dealers. In providing these services GPP focuses on premium client service, and in doing so offers both state-of-the-art technology solutions and an institutional strength in-house operational infrastructure. GPP offers a fully integrated, end to end processing model for the investment management lifecycle: this includes their own OMS and trade execution infrastructure, middle office client assets administration platform, plus proprietary back office for global settlement and custody.

Key Findings

- Very few in the wealth management currently outsource, but there is an appetite to outsource more in the near future.

- Firms are projecting optimistic continued growth but remain burdened by legacy systems that are inefficient and are failing to deliver value for money.

- Outsourcing can provide wealth management firms with technology that can streamline their business. Although it may not reduce costs, it has the potential to generate a strategic advantage if handled effectively and allow firms to focus all their attention on their core business activities.

- Interviews revealed what qualities wealth managers really look for in the technology. They prefer a modular service that is flexible enough to adapt to each firm's demands, which has an instantaneous implementation process that can get to work from day one of the partnership.

- When it comes to the providers themselves, firms prioritise certain qualities in the partner ahead of the actual product. Finding a provider who fully understands your business model and whose company culture aligns seamlessly with your own will lay the foundations to a successful long-term partnership.

- The existing outsourcing providers have a below par reputation in wealth management. To improve these conditions, service providers must develop their understanding of the industry and listen to the needs of wealth managers. The COOs we spoke to call for further transparency and clearer communication to reduce their frustrations with IT outsourcing and increase its value to the industry.

- Back office transactional-based functions such as asset administration, settlement and corporate actions are the key initial areas that firms will look to outsource.

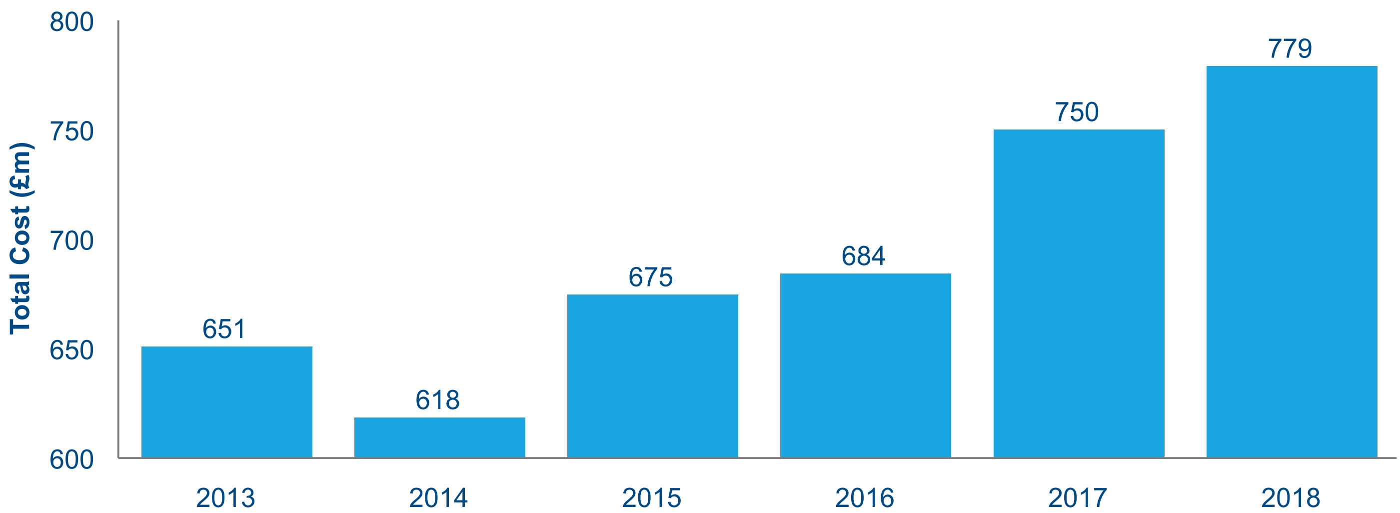
- If outsourcing cannot reduce costs, it is vital it mitigates risk and assets with firms achieving scalability (a major issue in the industry currently) through efficiency improvements.

1. Business Strategy

Current IT Spend

Across the whole UK wealth management industry, a total of £779m (11% of total revenue) was spent on IT in 2018. This is a combination of IT staff costs, information services costs, IT non staff costs such as systems and hardware and any outsourcing and group transfer costs relating to IT. This cost has been steadily rising and is an area that many firms are increasing their focus as they have invested in search of future rises in efficiency, whilst expanding digital services as they meet the needs of the next generation of tech-savvy clients.

Total IT Costs for the industry



The general perception is that, by outsourcing, it will not necessarily result in a reduction of costs. However, by outsourcing IT you gain access to a wider range of resources from the larger suppliers, can maintain control over these costs (due to an agreed contract), and can utilise the latest developments in technology and software that could help to drive future business growth, which in due course would boost revenues and improve profitability after efficiency gains.

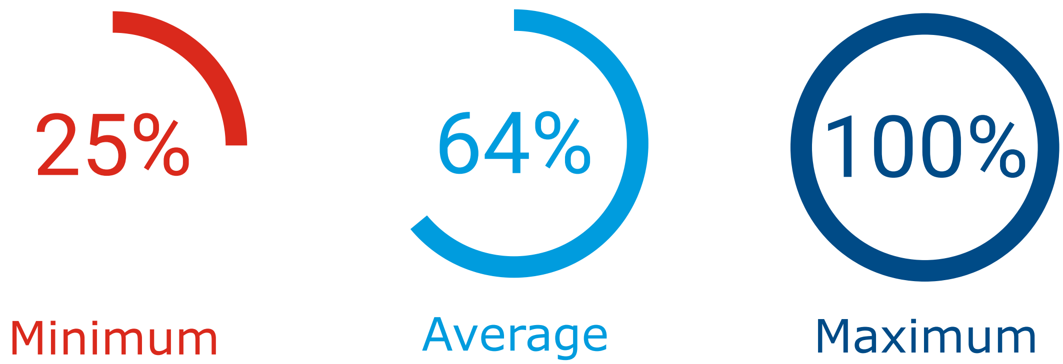
Future Business Growth

When asking the firms to consider their future business growth strategy, the majority (86%) favoured the organic growth approach, with the remainder searching for acquisitions to raise the value of their book of clients, resulting in further consolidation within the sector.

To then appreciate the extent of the projected growth, firms were asked by what percentage they envisage growing over the next 5 years.

The expected growth levels ranged from a modest 25% to a more ambitious 100%, with the average value of 64%.

In percentage terms, how much do you envisage growing your assets under management over the next 5 years?



To put this growth into context, in the 5 year period between 2013 and 2018, the average UK wealth management firm grew assets by 41%. Given the support that firms received from strong market growth in this period, it shows that many of the firms will need to perform exceptionally well to achieve their growth targets.

The driving force behind recent growth has been discretionary portfolio management. With the higher margins associated with it, especially when the service is standardised across multiple clients, many firms are encouraging both existing and new clients to take up these services. Also, with the introduction of services such as Managed Portfolio Services (MPS), clients of all wealth bands can be accessed and serviced in a profitable manner. This growth is expected to continue as, for almost all the firms interviewed, discretionary services are a key element of the business growth strategies.

The other service range where firms are expanding to help win new business is financial planning. Traditionally, this service has been provided by IFAs, which then outsource discretionary services to a wealth management firm. However, questions then arise as to who has the key relationship with the end client (the wealth manager or the IFA?) and where does the control therefore lie? Many wealth management firms are therefore looking to bring financial planning services in-house, to counter this problem and open more doors for inflow sources. In the case of 46% of the firms interviewed, financial planning services are an area where they envisage growth.

New Investment Approaches

With major global issues such as climate change gaining extensive exposure in the media, ESG (Environmental, Social and Governance) and impact investing have become hot topics across wealth management. Recent investor research from Compeer has shown that the demand for responsible investment strategies (such as ESG) from investors could be as high as 94% from those currently under the age of 40. This therefore should be an area that firms are concentrating on if they want to offer a proposition that will be attractive to the next generation.

40% of firms interviewed are aiming to make significant changes to their investment approaches to capture growth in areas such as ESG and Impact Investing. Although a positive move from firms, one may have expected this proportion to be higher.

"There is an internal drive towards ESG which stems from passionate employees in the investment team"

The move towards sustainable investing is therefore yet to reach its peak. Many firms explained the average age of their clients is over 60 and so the demand for these services is relatively low from their existing client base. However, this will change as awareness grows of these types of services. Firms without responsible investment strategies are therefore at risk of jeopardising future inflows, especially if the next generation of clients become the key source of new business.

Other Drivers of Business Growth

When asked for the main drivers of business growth, the top three responses given were:

- Technology - While it poses a challenge to all firms, if successfully managed it can be a driving force for growth and scalability. An efficient core of internal systems will enable a highly productive workflow on a daily basis. It can also develop a strong digital offering which allows firms to attract a high number of new, tech-oriented clients.

- Strong Investment Philosophy - Achieving above market rate returns for clients is a sure-fire way of keeping them happy. While they may have issues over the quality of service, demonstrating a strong investment philosophy will always attract new clients who seek a higher rate of return. This force may also include a greater investment offering such as ESG which is quickly gaining the attention of younger investors.

- Developing relationships and forming a trusting client base - When market returns have downturn periods, as seen in the fourth quarter of 2018, it pays off to have a strong and trusting client base who are willing to stick with your firm. Building this trust through a high level of communication and a consistently strong service offering will create loyalty among clients and build long term relationships. This will also tend to coincide with a higher number of referrals, which are the key source of new business for wealth managers.

Challenges to Business Growth

In a highly competitive industry, it is never going to be easy to win new business and achieve scale. The key challenges suggested by the firms that they are currently facing are as follows:

- Technology - Each wealth management firm is built on a foundation of IT systems. The process of finding the right combination of systems is a complex challenge. Firms expressed their issues with outdated legacy systems and a lack of awareness of providers in the market who can cater to their needs. There were also concerns with the time and resources required to integrate new solutions into their existing IT function.

- Regulation - Jumping through regulatory hoops can be a strenuous process. Heightened regulation has been a burden for several consecutive years as the FCA strives to clean up the industry. More firms are adopting governance, risk and compliance (GRC) software to automate this process and reduce the costs of compliance. However, the reality is the tsunami of regulation is likely to continue, compliance costs will continue to rise and firms will be required to allocate large resources to remaining compliant, thereby preventing them from focussing on driving business growth.

- Political uncertainty - For the past three years the uncertainty surrounding British politics has engulfed the wealth management industry. While another Brexit deadline approaches the pound becomes more volatile as markets slowly recover from the large shock at the end of 2018. This forces firms to make constant adjustments to their political risk profiles as the future remains unclear.

The importance of technology and its constraints

Occurring consistently throughout interviews, technology is vital in the attraction, engagement and retention of end investors. All firms explained how they believe technology can be harnessed to enhance the clients' experience, whether it be through a client portal, for instant portfolio valuations, a secure messaging tool, to increase communication with investment managers or a mobile app for services on the go.

While it is apparent the end client experience could be improved using modern technology, many firms expressed how the client's demand for tech is limited. The average client in wealth management tends to be over the age of 50, and as such they do not demand tech solutions to the same extent as younger generations. It is key for firms to update their technology offering, but many clients do not feel they need it.

A key constraint of technology is its inability to replace face to face meetings, which remain in high demand from clients. Developing relationships is key and for many they feel the need to have direct contact with an individual adviser that knows their life situation and their objectives and risk appetite. These relationships are developed by meeting with the adviser face to face. Proof of this is the lack of growth from robo-advisers. A key differentiator of these firms is the lack of direct contact with an adviser. Although they may be able to offer 'wealth management' at a lower charge, growth has been very slow as clients truly value the relationship and trust formed with the more traditional approach. This is understandable given the vast sums of money being invested and in many cases the results will impact the investor's livelihood (such as the amount they have in retirement). Some major players in the industry have tried and failed with launching robo-type services, costing them substantial amounts in the process.

It therefore shows that technology should be used to support the more traditional services (i.e. through digital portals and additional communication methods) but it will not be a direct replacement.

2. Current Systems & Partners

Wealth management firms are ambitious with their growth projections, but is their existing technological set-up capable of supporting this growth, are they open to outsourcing (and in which areas) and where are improvements required?

Existing set-up and supporting growth

As previously mentioned, technology has the potential to be a driver or challenge for growth, depending on how successful a firm is able to deploy it within their strategy. We asked firms if they believe their current technology model could sufficiently support their growth expectations.

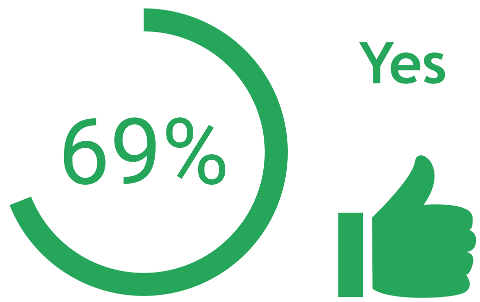
With more than half feeling the existing systems do not meet the desired mark, it shows that the recent investments in IT have not necessarily had the instant impact firms would have wished for and further changes are required.

A major concern is the existence of legacy systems. These systems by their very nature are out-dated, require substantial manual intervention and thereby restrain productivity.

Firms with legacy systems run the risk of losing their competitive edge within the market if their rivals utilise superior technology. The quality of security measures within modern tech is also far superior to legacy systems, making it easier to manage risk associated with IT. Also, from an investor's perspective, it has the potential to reduce the number of client inflows, especially with the younger generation who place a much higher emphasis on an advanced technology offering.

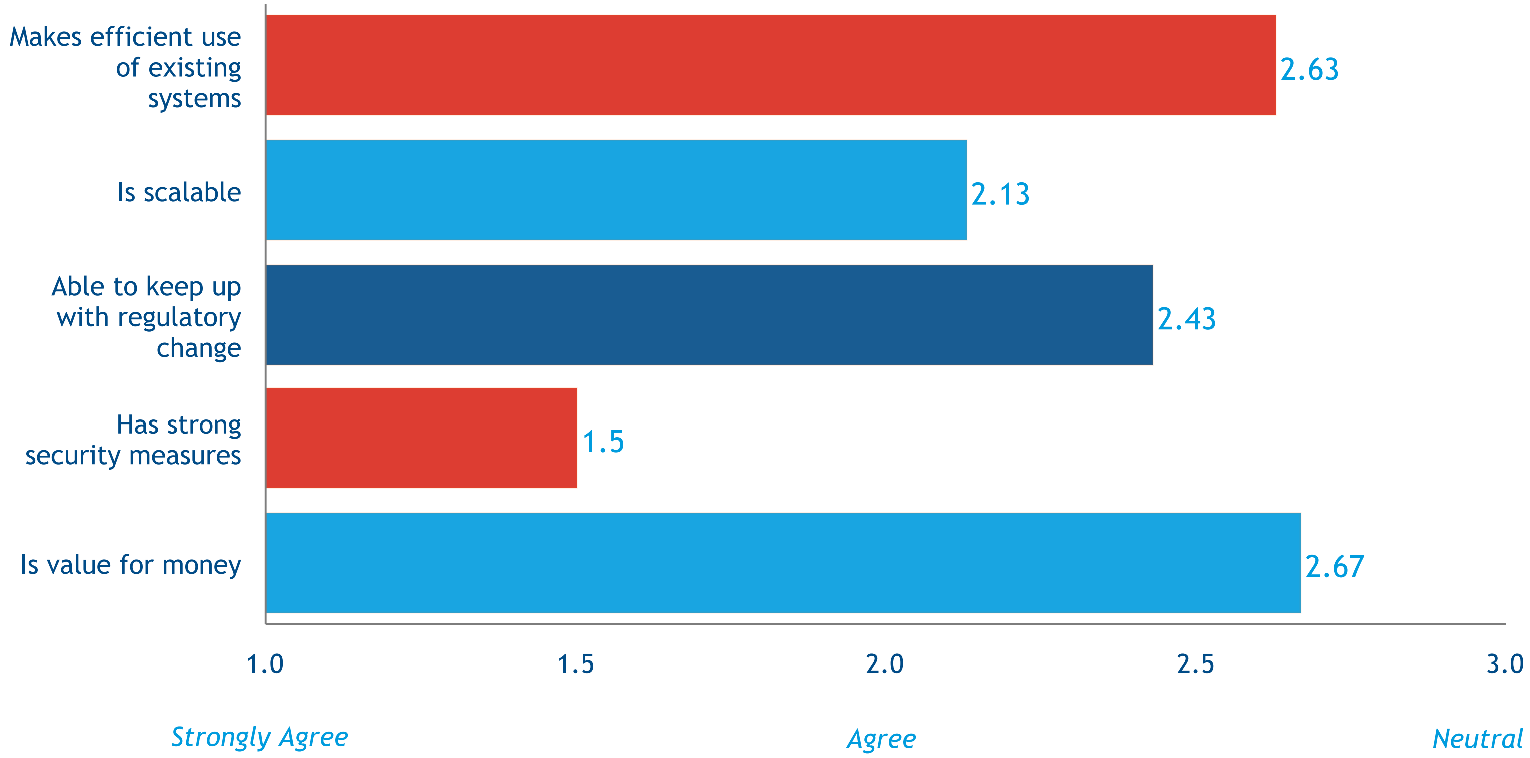
Do you believe your firm's current technology function could sufficiently support your level of expected growth?

Do you consider your current technology to be legacy?



The industry therefore should be in a state of change, upgrading these systems. But this is by no means an overnight fix and for many it requires a substantial change (at a large expense) – a step that some are currently unwilling to take. Given the high margins and good growth achieved by many firms in recent years, one can understand why they take this view. It therefore may take a major shake-up in the industry, such as through the likes of Google or Amazon setting a up a wealth management offering with all the latest software, to jump start the move to replace legacy systems.

Another reason for technological inertia for some in the industry is that although they class their systems as legacy, their views on the existing set-up were higher than expected.



The figures show the optimism COOs hold regarding their IT models, indicated by the fact no statement scored an average below 3 out of 5 – the point at which the majority would be disagreeing with their IT model meeting a criterion.

The best performing criterion, by a significant margin, is the existence of strong security measures. Firms commonly strongly agreed that their security measures were sufficient, which is both encouraging and understood given the rise of cyber-attacks in recent years. The risk of cyber-attacks has never been higher, as technology develops, the available tools and threats from hackers become more sophisticated. Common threats such as phishing, malware and viruses must be deterred by a mixture of defence mechanisms and ensuring staff are educated about these risks to safeguard sensitive data.

A somewhat surprising result was the large proportion of firms that feel their existing set-up is scalable. Data from Compeer's business performance benchmarking survey contradicts this view with only a handful of firms consistently achieving scalable results over the last 5 years (i.e. achieving revenue growth, whilst also maintaining or improving profit margins). There may be other areas outside of technology that are impacting scalability results. However, it appears this may be an area that firms need to take a closer look at to fully understand if their existing systems are restricting the firm's scale potential.

Adapting to regulation has been a key source of IT investment in recent years (some firms have incorporated specialist governance, risk and compliance software to improve the efficiency of their compliance departments). With many being neutral in terms of their ratings of their IT model in terms of coping with regulation, it would suggest the investment will not stop in the coming years and further adaptations are required.

The two areas where the firms believe they are weakest were the efficient use of existing systems and achieving value for money. These are likely to be interlinked and transpire with the existence of legacy systems. An overhaul of systems will have a high upfront cost, but the payback would be it leading to substantial efficiency gains and therefore delivering better value for money over the long term.

Areas for improvement & considering outsourcing

User experience is one of the main areas for improvements within technology. Firms aim to give their clients further accessibility to their services through a mobile app, client portal and secure messaging systems. This intends to give the client more control to view the status of their portfolio on demand and create a clear and secure stream of communication with their investment manager.

When looking internally, firms are aiming to use technology to improve their investment management platforms and reporting systems, whilst also improving efficiency through automation - saving their front office professionals valuable time. When we asked firms about the role outsourcing can play, 75% agree that it can be used effectively to drive front office productivity. A higher degree of automation will provide more freedom to front office staff who can then spend more time managing the relationships of their clients (boosting client trust and increasingly the likelihood of referrals) or looking for new business.

After looking at the systems available, we asked firms how they perceive the current level of maturity among IT outsourcing service providers in UK wealth management. The replies showed how frustrated firms are with what is currently available to them. Overall the general view is that the current level of maturity is poor.

The gap between the solutions provided and the demands set by wealth management firms is too wide. Responses show a level of frustration as firms believe service providers do not fully comprehend exactly how wealth management firms operate, and therefore the technology solutions they provide are not able to meet all their needs. This can lead to service providers promising solutions they cannot provide and further prolonging the firm's system / provider selection process.

> "Most providers will offer 80% of a solution, but the remaining 20% is what will kill you"

Service providers need to engage further with the wealth management firms, open a dialogue and listen to their demands. This will enable providers to tailor their systems to provide the exact solutions rather than basing these on assumptions.

Our next question focused on the benefits of outsourcing. We asked firms if they believe outsourcing can provide a strategic advantage and the results showed a split in opinions.

The majority of firms in our survey do believe outsourcing can provide a strategic advantage. The main benefit provided by outsourcing is access to expertise in a given area. Working with a specialist provider gives the firm access to a wealth of knowledge which can be used to enhance their IT function. Depending on the other clients of the service provider, the partnership could also enable scalability. If the provider has experience working with larger firms, wealth managers can leverage their knowledge, helping them scale up successfully. Firms also stand to benefit from any innovation undertake by the provider, which can give them the edge over their rivals in the industry.

> "It is about focussing on what you are best at, which can improve the overall client service"

However, outsourcing will not be the flavour of the month for all firms, with some suggesting it does not provide a strategic advantage. They believe that the strategic advantage comes from within and is about the service differentiation offered to the end client, rather than being driven by an outsourcing provider. However, providers can allow firms to streamline back office functions, by operating on specialist systems to increase efficiency. This therefore allows a firm to spend more time on their core business activities and generate a competitive advantage.

One thing both groups agree on is that if outsourcing goes wrong, it can be a significant disadvantage and cause major issues – management of the outsourcing agreement is therefore vital! This is why firms will spend a significant length of time selecting the most appropriate provider, whilst considering all their options as to whether outsourcing is an appropriate solution for them.

Outsourcing specific functions

If firms go down the route of outsourcing, to maximise the benefit to their business they must decide which areas will benefit from external help and which should remain in house. To find this out we asked firms to rank a list of functions which to them would benefit the most from being outsourced.

Which functions stand to benefit the most from outsourcing?

1st

Asset Administration

2nd

Transaction Processing and Settlement

3rd

Corporate Actions

Back office functions that currently have many manual processes were the most commonly suggested.

Firms believe asset administration, such as custody and fund accounting, stands as the function to benefit the most from outsourcing.

"It is a no-brainer to outsource anything we view as commodity services"

Other areas which would benefit greatly are transaction processing and settlements and corporate actions. These are very IT dominant functions, and therefore can benefit significantly from automation. This can reduce labour intensive processes and increase overall productivity.

Client reporting was far down the list. Although the industry is moving to a digital era of reporting, this is a function firms will keep in-house as the reports will need to be bespoke for each firm. By outsourcing reporting they would lose control and see little benefit from it.

3. The Ideal Outsourcing System & Partner

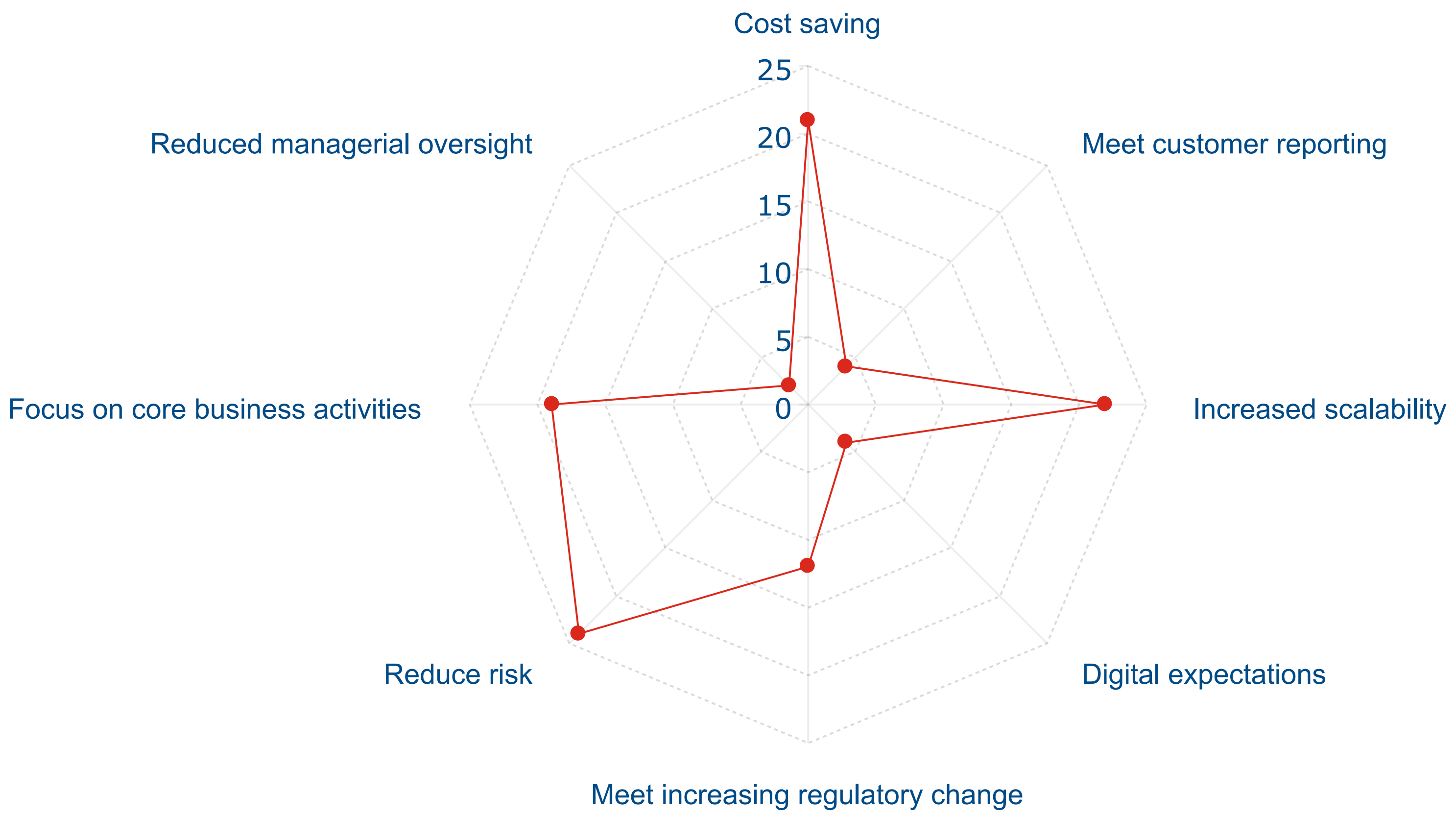
From the previous section we are aware of the key functions that firms believe could be worthwhile outsourcing. But to get the decision to outsource over the line a viable business case will need to be formed.

Building a business case

What are the most important factors when forming a business case to outsource?

(3 points for number 1 ranking, 2 for number 2 ranking, 1 for number 3 ranking)

Total Points



Results show the most important factor for firms when looking to outsource IT is to reduce risk, closely followed by increasing scalability and saving costs.

Risk is nullified by accessing the resources of a larger supplier with the right level of expertise. However, for compliance matters not all risk can be passed on to the supplier and so the firm will have to maintain a certain level of control.

Many firms target cost savings by outsourcing. However, the reality is this is not always the case. Instead outsourcing is thought of as a method of materially improving efficiencies, delivering better productivity and driving business growth – all of which mean larger revenues. Therefore, some are willing to tolerate the costs of outsourcing, provided their expectations of business improvements are met.

Scalability is a hurdle many firms are struggling to clear. Therefore, many firms are open to external help from an outsourcing partner to scale successfully as their core business grows.

The modular nature of many services allows firms to manage the costs based on usage, so they can then purchase and use more of the software as they grow over time.

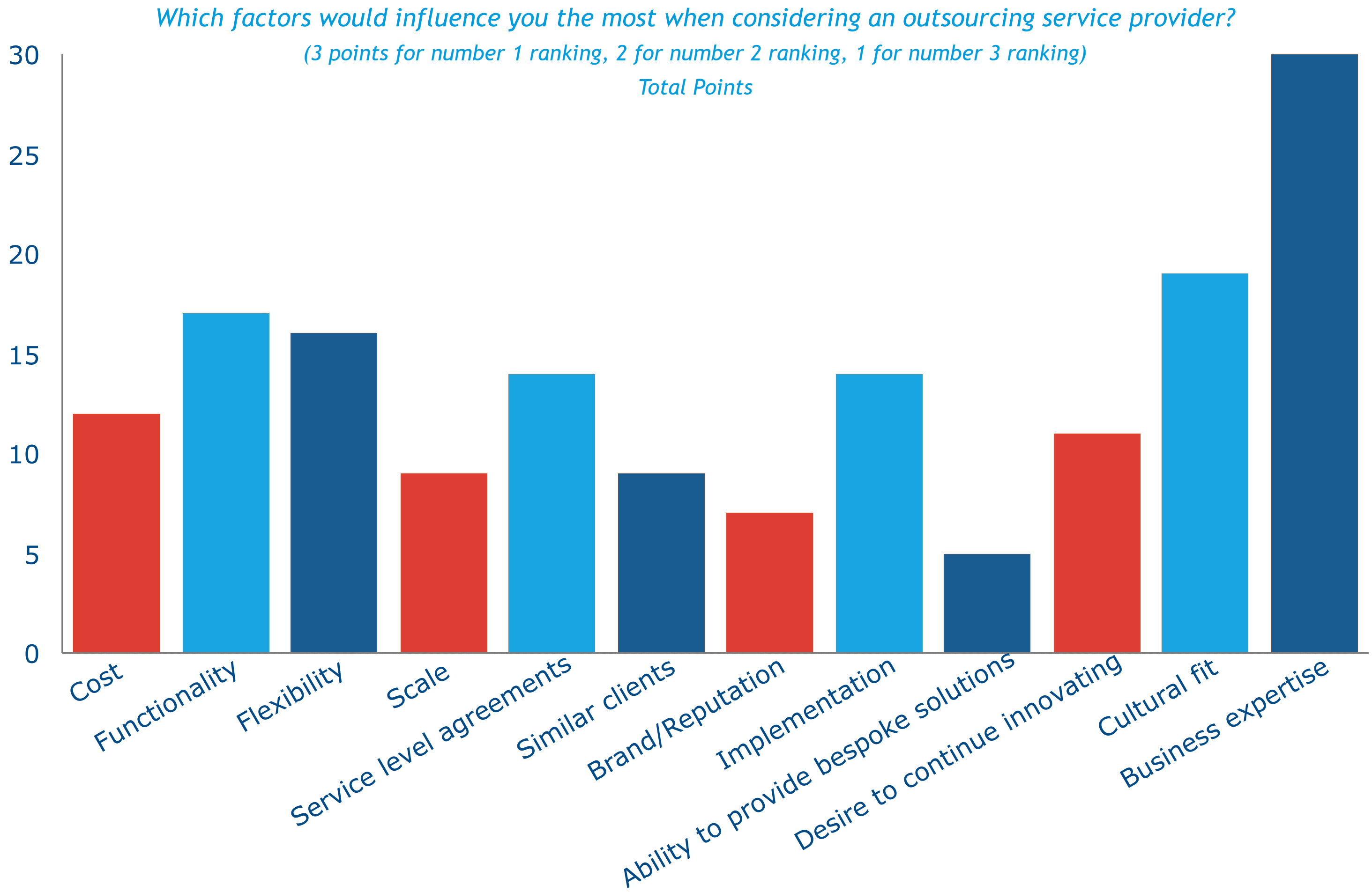
Reduced managerial oversight was not a large concern for many firms and came in the lowest ranking of all factors. Firms said they are confident that their service level agreements are water tight, so they don’t mind placing the trust in the service provider to do the job they are paying for.

In providing solutions to the industry, service providers play a key role in driving innovation. They not only provide access to specialised solutions in the present but shape the future of technology in the industry. Many firms would not be able to cover the costs of research and innovation themselves. Therefore, they rely on the scale of technology providers to develop existing products and new technologies. While wealth management firms benefit from the cost burden of innovation lying with service providers, they also benefit from higher competition between service providers, who are battling to develop the best technology.

However, issues may arise if the direction the service provider is taking does not align with the wealth management firm once they are locked into a long-term contract. To avoid this, firms must discuss their strategy with the provider and make sure their service level agreements are robust before entering he partnership. Firms expressed how important it is to form a partnership based on a similar strategic ideology to ensure both parties are heading in the same direction. During the partnership it is key to maintain a high level of dialogue with the provider and encourage them to develop in a way that matches the direction your business model is heading.

Selecting the right provider

Finding the right partner is essential. This process requires thorough research and patience. Rushing into a deal with the wrong partner can be catastrophic if the technology does not function how you need it to, if the cultural fit is poorly aligned or if the provider heads in a different direction to the firm. We therefore asked firms to rank a list of factors which influence them the most when considering an outsourcing partner.



The results show partnerships are influenced by far more than just the underlying technology. The top answer, by quite a margin, is the business expertise of the firm. This shows how vital it is to find a provider who fully understands how a wealth management firm operates. Many firms expressed their frustration over providers making assumptions about the wealth industry (e.g. the providers have worked in asset management and assume similar technology is appropriate for wealth management). These issues can be eased through detailed market research, clear communication with firms and staff with experience of the industry. Firms can tell early on how well the provider understands the firm's issues. Partnering with a firm who demonstrates business expertise is therefore essential to a fruitful relationship.

The second highest factor is also not based on the product itself; the cultural fit of a partnership. At the end of the day if you do not get along with the service provider's staff, how can you expect the relationship to thrive? Again, firms said this is an easy factor to measure. It can become apparent very quickly, from dialogue and meetings, if the culture of the provider matches that of your firm.

In third, the first factor related to the technology itself. The functionality of the system being provided must meet the demands of the wealth manager. If the technology does not function well then the project will fail. This ties in well with the fourth factor; flexibility. The system must be able to adapt to the needs of the firm, so that it can provide them with a solution. Then it must also be a smooth process to implement the system, preventing any excessive and unexpected costs that will send the project over budget.

The reputation of the service provider and their other clients are seen as moderately important factors to firms. If a firm can see a service provider is capable of dealing with clients of a similar calibre to themselves, then it is an encouraging sign they will be able to handle their business. The service provider must have a robust reputation to demonstrate their trustworthiness as a potential long-term partner. While these two factors hold some influence, firms said it is not vital to score highly in these areas as some smaller, newer firms may be just as good without the same reputation or client base.

So how do firms find these providers?

The first step is often to select a consultant with the relevant knowledge of the providers. However, there will be cost implications linked to this and so other firms will opt to conduct the research in-house and through conversations with others who have experienced outsourcing agreements. After all, the wealth management industry thrives on referrals for new business and so it makes sense for them to value referrals when it comes to major business decisions.

To become aware of new providers in the market, firms listed several sources of information;

Desktop Research | Networking Events | LinkedIn | Financial Services Press

Each firm has a different approach and unique process for finding a provider, but each boil down to a similar set of core objectives:

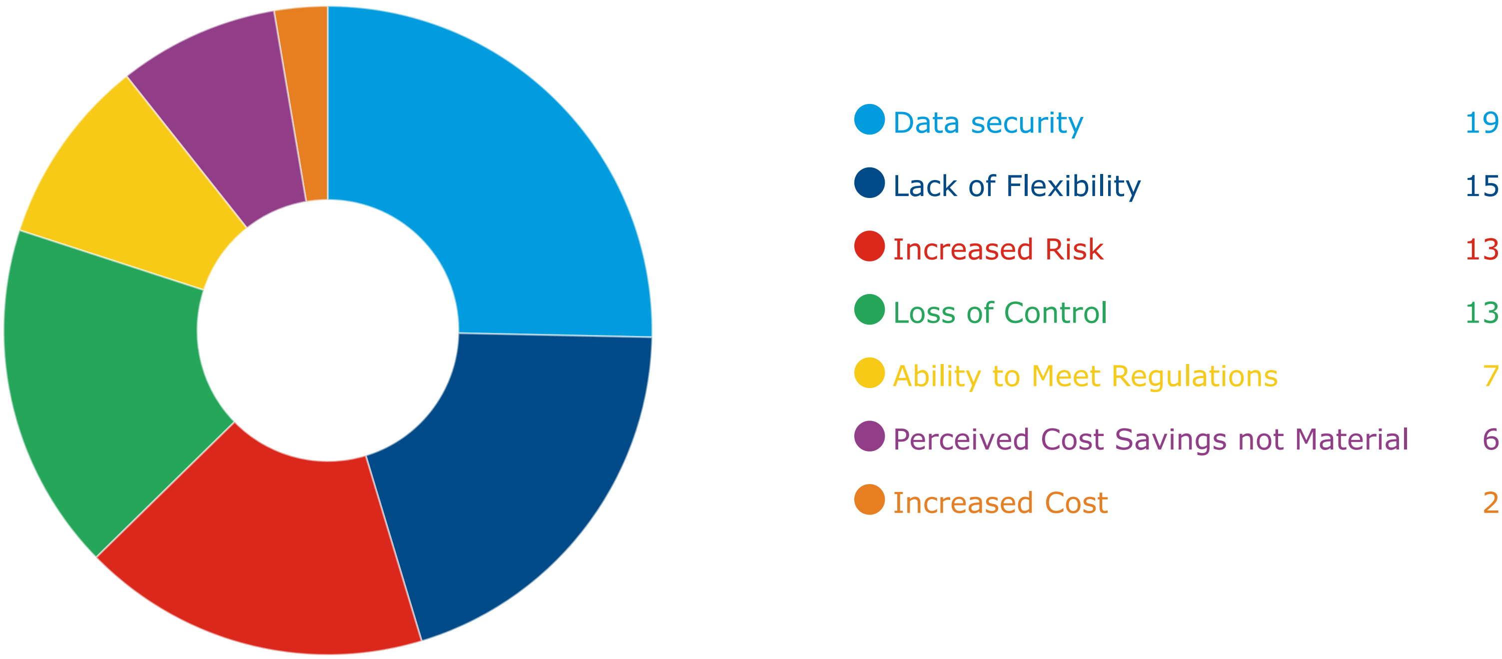
Can the project reduce cost, reduce risk or increase the quality of service to their end clients?

If some or all of these objectives can be met, then the firm will take the next steps to form a business case to outsource. This will involve a rigorous process whereby the decision is considered by senior managers and then assessed by board members for a final verdict.

Concerns regarding outsourcing

With the distinct lack of outsourcing currently in wealth management, there must be concerns within the industry. The chart below indicates the main concerns voiced by firms, which we followed up by asking how service providers can mitigate these concerns:

What are your main concerns about outsourcing?
(3 points for number 1 ranking, 2 for number 2 ranking, 1 for number 3 ranking)
Total Points



The number one concern firms have with outsourcing is over the security of data. A provider must be able to demonstrate they have a robust data protection strategy in place as they will be dealing with large quantities of private client data. A hack or data leak could result in severe penalties from regulatory bodies and fatal reputational damage – such as failing to comply with the recently introduced GDPR.

A lack of flexibility in the technology is the second most concerning issue. Many firms we spoke to said they have experienced rigid systems which were not flexible enough to adapt to their requirements. No matter how cutting edge the technology provided is, if it fails to adapt to the task at hand then it will generate little or no value.

The two least concerning issues cover the cost of the partnership. While this may come as a surprise, as firms are always concerned about their cost structure, some firms we spoke to believe outsourcing cannot be used as a cost cutting strategy. Outsourcing may be beneficial for managing costs, but its key aim should be to improve efficiency and generate more value and business.

While each factor can be managed in specific ways, the main response firms provided when asked how to reduce these concerns is through increased transparency and clearer communication. Wealth management firms are far more likely to partner with a service provider who is open and upfront about their technology. Firms said they appreciate a provider who can talk about the limitations of their technologies, as well as its strengths, so they can fully understand what is on the table. The real value from outsourcing comes from the long-term relationship with a service provider who understands the needs of the wealth manager and can adapt their technology to manage ongoing issues.

Modular versus one size fits all

When it comes to the systems available, there are two main categories. First are the firms who offer a one size fits all solution and second are those who provide a modular structure which separates the front, middle and back offices.

Two thirds of firms said they would prefer a modular structure over an all-inclusive front-middle-back office platform. With this structure, firms can pick and choose the most appropriate modules available and integrate them into their existing IT model. The flexibility of this makes it much more popular among firms who can trade out and upgrade specific areas of their IT function with greater ease than one uniform system.

> "In the process of building a platform you need to ensure the integration process is smooth"

In theory, firms would all like to have a one stop shop platform. One that is modern, flexible and cost effective. However, firms told us that this solution does not currently exist. This is why a modular structure has become more popular, as firms can pick the best of breed in each area of their IT function to suit their exact needs (provided the modules are easy to integrate and capable of communicating with one another).

Finally, once firms have selected a partner, we asked them what their preferred charging structure would be. The results show the decision is quite close, with 60% preferring a tiered bps model with the remaining 40% choosing all-inclusive transaction-based pricing. The main request was that the costs are transparent and known up front, this makes it simpler to analyse and compare between providers.