Evaluating Risk and Efficiency in Corporate Actions Processing at Major Investment Banks

London-based market intelligence consultancy Z/Yen has conducted detailed research into sources of corporate actions risk confronting the investment banking sector. Jeremy Smith, Director of Finance at Z/Yen, reports on key findings and policy recommendations emerging from this study

Introduction

In 2005, Z/Yen carried out a wide-ranging study into the processing of corporate actions for a consortium of eight investment banks. This was the second survey focusing on corporate actions, the first having been performed in 2003.

The study was based on individual interviews, with each participating bank using a structured questionnaire developed by Z/Yen and the sponsoring banks. Data was submitted in July and August 2005.

Organisational Structure

Seven of the eight banks participating in the study shared a similar high-level operating model – ie an initial split between corporate actions and dividends and then subsequent product alignment. The other bank was more event-aligned – ie split by market/region. However, underneath this, there were a wide variety of sub-models, with no one model predominant or obviously more efficient.

Current structures seem to have been determined more by the history of the organisation, rather than by future strategy (eg automation and risk-reduction). However, client demands, both internal and external (especially prime brokerage) are beginning to play a greater role in determining future structural change.

London is a key regional processing centre supporting European, but also US and Asian, securities (see Fig 1).

Fig 1: **Regions Supported from the UK**

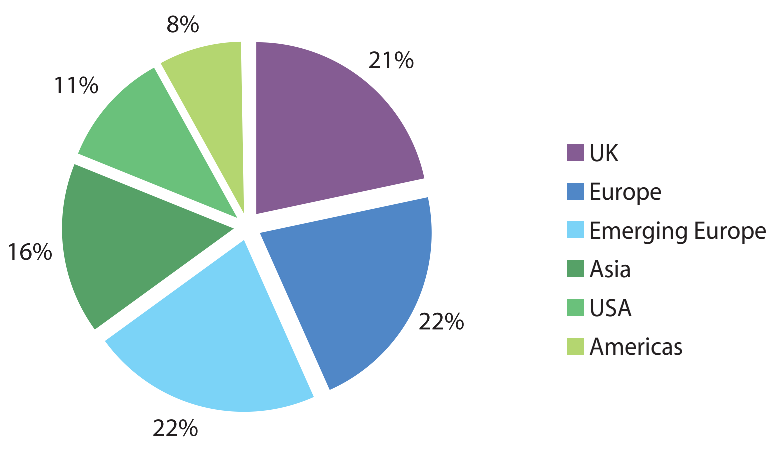
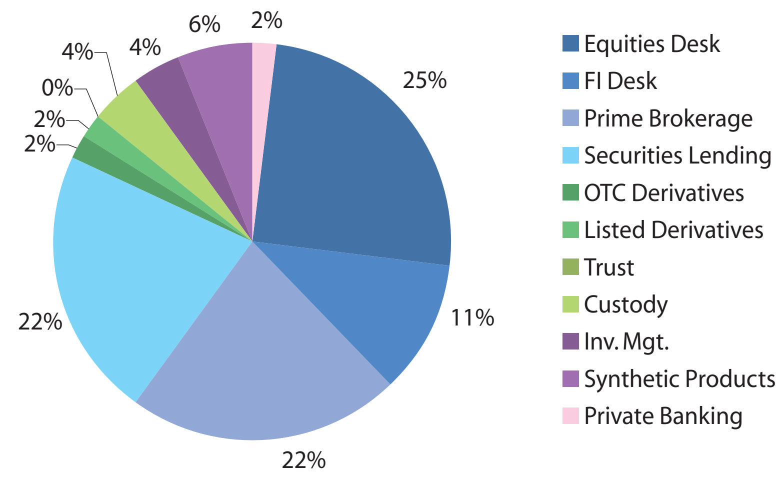


Fig 2: **Percentage of Operations Headcount by Business**



Businesses Supported by Corporate Action Groups

Traditional equities trading businesses continue to attract most effort, although some banks now have more focus on prime brokerage and securities lending.

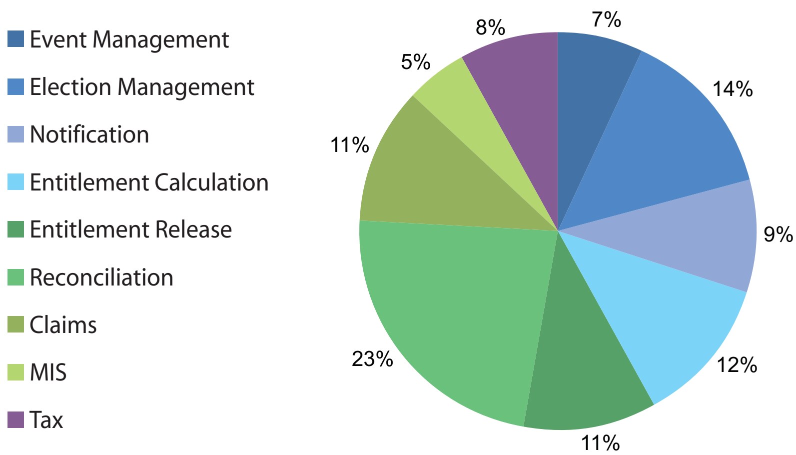
Operations headcount varied significantly from bank to bank, depending on regions covered, but also on services provided and the extent of automation (see Fig 2).

> The headcount range was 22 to 101, with an average of 55.
> Over 50 per cent of effort was focused on Europe and Emerging Europe.

Services Offered by Operations Groups

Overall, the 'post-settlement' aspects of reconciliation, claims, MIS and tax attract nearly 60 per cent of operations effort, while the potentially more risky areas of election and event management, calculation and notification require less effort (Fig 3). This possibly suggests that banks have historically invested more in automation of high risk areas. However, with increasingly higher volumes, the costs and customer focus of post-settlement activity are now attracting greater focus.

Fig 3: **Operations Headcount by Service Provided**



Current Processing Focus and Issues

Deadlines across the market are being squeezed. Agent banks are being pressurised by brokers to offer formal cut-off times for mandatory and voluntary corporate actions that are increasingly close to the market. Additionally, increasing sophistication among clients and business units is adding pressure to operations as 'turnaround' windows get smaller.

The current focus on operational risk management has led to stricter notification policies, designed around control and risk mitigation.

The combination of tighter deadlines and the need for greater control has created a minefield of potential timing issues.

Tax reclaims are generally handled by specialist areas. The point of filing is generally determined by the market, rather than by internal processes.

The management of proxy voting and, specifically, class actions is a relatively new, but increasingly important, area of focus.

IT Support & Automation

The majority of banks' corporate actions systems have been developed in-house. There are few off-the-shelf packages available, reflecting the historically complex nature of the product. Banks have typically been put off external vendors because of perceived issues of cost, inconsistency and complex procedures for integration with internal systems.

Manually intensive processing finds banks in a 'catch-22' type scenario. A very manual process cannot be easily automated, owing to the resource needed to hand-hold and verify the efficiency of the changes. One bank reported that a system that had been automated, but the staff were still checking manually, just in case!

The extent of automation at the 8 banks surveyed is shown in the table below:

	Dividend			Coupon			Mandatory Corporate Actions			Voluntary Corporate Actions		
Event Management						17%						
Election Management							33%			33%		
Notification							13%		25%	13%		0,25
Entitlement Calculation	13%		50%	13%		50%	38%		25%	38%		0,25
Entitlement Release	38%		13%	29%		14%	63%			63%		
Reconciliation	38%			43%			38%			38%		
Claims	50%			43%			63%			63%		
MIS	13%			14%			38%			38%		
Tax	38%			43%			86%			86%		

Data Processing

All banks dual source their data and, in most cases, this involves third-party vendors and agent banks. From an agent bank perspective, Citigroup and BNP Paribas (as local agents) are predominant. They are seen as mostly timely and accurate, but with occasional blips in certain markets.

Performance Measurement

Banks have established detailed performance measurement, which is reviewed periodically (typically weekly by team leaders and/or Operations Management). Several also provide monthly, quarterly and/or year-on-year information packs for senior management review, with a clear objective of risk management.

There is increasing focus on exceptions and aged items, use of key risk indicators, system capacity and exposures due to breaks and fails.

Service level agreements are often used to support complex service expectations, either with agent banks, specific businesses or, in one case, an offshore processing office.

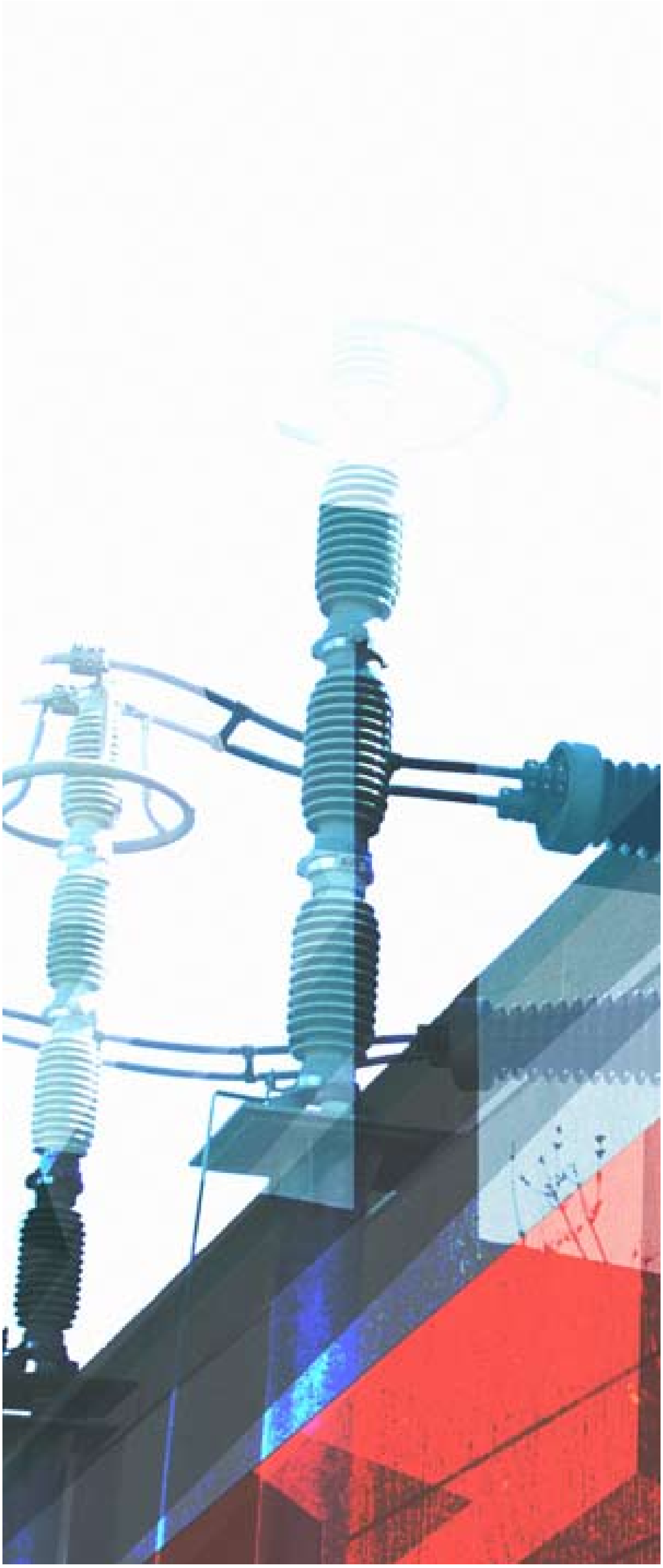
Risk Management

Corporate Actions have historically been viewed as a 'risk' area for operations, with errors being driven by incorrect or late instructions, unreconciled positions and tight deadlines. However, since 2003, most banks have updated their operational controls and participants agreed that high trade or event volume is no longer the key driver of risk and potential losses.

Banks reported four common themes of corporate actions risk: financial, regulatory, franchise and market. All banks placed great emphasis on the identification and mitigation of risks and the reporting of errors.

Errors which had resulted in significant financial losses (over £10,000) included:

- Aged balances which were problematic, or uneconomic, to reconcile;
- Disputes with counterparties and agent banks;
- Calculation errors during compilation and instruction of elections;
- Communication errors (eg information not passed correctly between asset servicing groups);
- Manual processing (eg election requests received outside of an automated process);
- Missed faxed counterparty elections;
- Unreconcilable entitled positions (eg positions not fully reconciled at the point election made);
- Common knowledge, but no documented procedure (eg the standard procedure was performed, but for a market where doing so created an incorrect record date position);
- Late booked trades, which created an incorrect position;
- Exception to regular procedures (eg use of different courier service led to election being received at the registrar late).



Recommendations

The following recommendations were derived from the data analysed and from discussion with the participating banks.

Develop organisational structure from business strategy, global/regional approach and client demands. While internal efficiency can be measured by Key Performance Indicators and client feedback (internal and external), the structure itself does not determine operational efficiency. It's OK to be different!

Ensure efficient planning, execution and success-measurement of **change programmes:**
> Work with businesses to plan future change and look for regional/global synergies (particularly systems);
> Engage all parties that will be impacted early on, and communicate status of change;
> Where possible, establish change teams, rather than relying on the (often already stretched) practitioner resource;
> Establish and monitor success factors (eg performance measurement, benefits realisation programmes, service level agreements etc).

Unlike securities trade execution, confirmation and settlements processes, there is little evidence of **standard industry tools** or practice. Banks need to **work together** to develop models and/or apply pressure to potential or existing providers.

Ensure **risk areas** are identified, communicated and documented. Control measures should be designed around lessons learned.

Keep formal track of **operational losses** to allow integration into banks' operational risk programmes and to support cost/benefit analysis of system upgrades.

Leverage agent banks for the provision of information, tighter deadlines and standardisation of processes and systems. Agent banks typically roll up all aspects of corporate actions services into a basis point fee on the value of assets under custody (they too have difficulty calculating a per-item cost). The agent is an expert in the market and so can be leveraged to provide 'value-added' services at no extra cost.

Automate where possible, but not just for 'automation's sake'. Where possible, the Corporate Actions group should drive automation, with future planning for integration into 'wider' in-house systems.

Keep **lines of communication** open between internal groups, to ensure consistency of coverage and the interaction with 'other' groups such as Tax, Proxy Voting and Legal & Compliance. ■