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Rationalization of corporate action processing through outsourcing

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Processing of information regarding corporate actions in overseas markets is seen by some as a heavy burden for asset management companies. Outsourcing of this function is one way for asset management companies to boost their competitiveness and improve operating efficiency. The example of a US asset management company that has outsourced CA processing should be instructive for many asset management companies under perpetual pressure to improve competitiveness and efficiency.

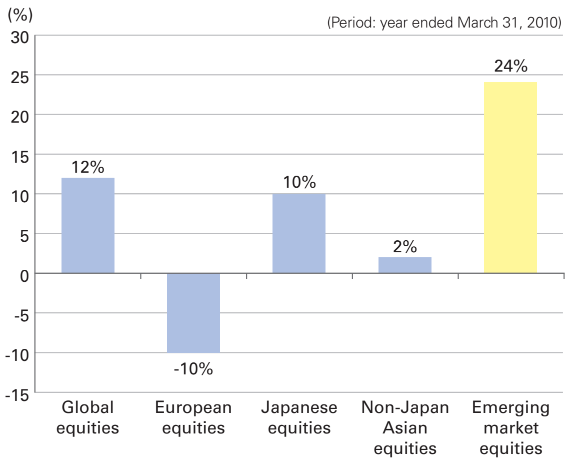
CA information is important for global asset management

Corporate actions (CA) take many forms, including mergers, dividends, and stock splits. CA information signifies management decisions. It often also has an impact on companies' stock and/or bond prices. As such, CA information is important for stakeholders. Even for asset management firms that invest in corporate securities, CA information is important information that not only requires processing but is also deeply relevant to investment decisions.

Currently, some 65% of global corporate actions involve US issuers[1]. While US issuers still account for most corporate actions, CA information volumes are growing in North Asia, South America, and Europe, according to corporate action message tracking, which has been increasing for the past five years[2]. Perhaps in response to such trends, Thomson Reuters, a major information provider, expanded its CA data coverage in Europe including Russia in late 2009.

Recently, institutional investors have increasingly been investing in emerging market equities in the expectation of long-term economic growth[3] (see Exhibit). Asset management companies globally are strengthening their emerging market investment capabilities[4]. CA information is therefore likely to become even more important for asset management companies.

Exhibit. Institutional net flows by equity asset class (in percentage terms)



Source: eVestment Alliance, March 31, 2010

Risks posed by emerging market CA processing

As CA information increases in importance, entities such as the Society for Worldwide Interbank Financial Telecommunications (SWIFT) are standardizing CA data to improve processing efficiency and reduce operational risks. However, standardization of CA data is proceeding more slowly in emerging markets than in developed markets. Emerging market CA information is still largely processed manually[5] due to IT infrastructure deficiencies. Additionally, processing of emerging market CA information requires highly specialized personnel due to differences in tax laws among countries and widespread use of languages other than English. CA processing consequently imposes a heavy burden on relatively lightly staffed financial institutions such as asset management companies.

In Japan, for example, retail investors actively invest overseas through investment trusts and therefore it can be stated that to a certain extent Japanese retail investors are ahead of their global peers in terms of exposure to overseas investments such as emerging markets. Meanwhile however, asset management firms perform most operations related to overseas investment in-house. In Europe and the US, where the stage is set for emerging market investment to increase in prevalence, interest in improving operating efficiency is already high among asset management companies. Many asset management companies plan to make operational improvements in the near future[6].

Below is the example of a major US asset management company that is utilizing outsourcing to improve CA processing efficiency and reduce related risks. Being closely related to investing operations as noted above, CA processing can be characterized as a core business function of asset management companies. Outsourcing of this function in pursuit of greater efficiency is therefore a bold decision in a certain sense.

Example of US asset manager that has partially outsourced CA processing

Company A, major US asset management company, has outsourced certain CA information processing functions to a major global custodian since the mid-2000s[7]. As a result of doing so, Company A has improved processing efficiency with respect to (1) CA information gathering, (2) CA data scrubbing (i.e., checking and, as necessary, correcting data), and (3) transmittal of information on corporate actions that offer shareholders a choice of options.

CA information gathering at Company A was previously done by investment accounting staff in the middle office. These staff gathered individual information releases from multiple information providers (custodians, brokers, information vendors, etc.). Today, by contrast, Company A obtains all CA information via the global custodian's information hub[8].

Company A previously outsourced CA data scrubbing to the custodians it uses. In some cases, it re-scrubbed CA data in-house using data from multiple sources. Processing CA information on a timely basis proved to be difficult, partly because information had to be repeatedly reconfirmed with custodians. Currently, however, the custodian scrubs CA data in large batches using an in-house database, enabling Company A to receive nearly error-free CA information on securities it owns on a timely basis.

One area in which Company A has benefited particularly greatly from outsourcing is processing of information on corporate actions that involve a choice of options regarding participation in an event. Although corporate actions with such options account for less than 10% of all corporate actions[9], their processing is surprisingly burdensome. Such corporate actions require front-office portfolio managers to decide on an option and issue instructions to not only their in-house portfolio accounting system but also custodians. Company A previously had to issue instructions to two custodians of investment trust assets and 30–40 custodians of assets in institutional investor accounts. Additionally, most of these contacts with custodians were done manually. Corporate actions with a choice of options consequently imposed a heavy workload on Company A's back-office staff. Today, however, the custodian to which Company A outsourced CA processing gathers instructions from portfolio managers and automatically forwards them to all custodians, reducing the risk of communication errors and omissions.

By outsourcing such CA processing to a global custodian, Company A now employs one or two personnel to do the work previously handled by a staff of seven.

Potential for improvement in CA processing through outsourcing

Errors in scrubbing and interpreting CA information (data) result in annual losses estimated at $10 billion globally[10]. Asset management companies have been endeavoring to improve operating efficiency and reduce operational risks since before the 2008 financial crisis, but achieving such objectives has become even more important in the wake of the markett downturn ensuing from the crisis. In terms of CA processing, asset management companies must upgrade their risk management by strengthening in-house

CA information gathering and data scrubbing capabilities to reduce the risk of major losses. Such upgrades are costly. Meanwhile, asset management companies must also successfully address the difficult challenge of improving their overall operating efficiency. Their best option may be to pursue maximal operating efficiency by discontinuing in-house controls and outsourcing CA processing to an external vendor with better IT systems and more expertise CA processing, thereby allowing the asset management company to focus solely on necessary monitoring. In any case, for asset management companies seeking to boost their competitiveness through diversification of investment strategies and product offerings, improvement in CA processing efficiency is a key issue throughout the global asset management industry.

Note

1) "A roadmap to achieving STP for corporate actions" (Journal of Securities Operations & Custody, February 2009)

2) A-Team Group (January 23, 2009)

3) Quarterly Global Asset & Flow Review (eVestment Alliance, 1Q 2010). Report on a survey of mainly US institutional investors.

4) Financial Times (January 14, 2010)

5) Via fax, telephone, e-mail, etc.

6) "The TowerGroup Operational Risk Assessment Survey: A Focus on Investment Management" (TowerGroup, August 2010). Report on a risk management survey of 42 European and US asset management companies.

7) Company A uses CA processing outsourcing services provided by a major global custodian.

8) Such hubs are trade messaging network systems that link asset management companies with numerous third parties, using various messaging formats developed in the early 2000s.

9) Percentage of corporate actions involving a choice of options (e.g., whether to reinvest dividends) as reported by Company B, a US asset management company (NRI America survey).

10) "Corporate Actions Processing: What are the Risks?" (Oxera, May 2004)

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