IBACAS
THE INSIDE TRACK

Corporate Actions Risk Management – Is It Working?

Corporate Actions and Income event processing is widely recognised as the riskiest area within Operations. Despite this, there has been limited success in achieving reasonable STP rates and even less success in measuring the associated risk values.

In a world where there is an ever increasing focus on regulatory issues, it seems bizarre that this situation exists. All seasoned Asset Services processors and managers will have a long list of anecdotal stories relating to losses or near losses, some running into 7 or 8 figures. Despite this, risk control / measurement practices relating to Corporate Actions are very basic.

Most Operations Managers use a "red / amber / green" or "high / medium / low" method that is usually based solely on the event type – and sometimes takes into account the country of issue.

The main problems with this approach are:

- This method only produces relative risk ratings and not absolute risk values.
- It takes no account of the underlying operating model.
- It ignores the relative entitled position sizes and position / trade types relating to the underlying event.
- It does not take into account levels of processing optimisation and control, regional variations, or staff competencies.
- It ignores factors outside of Operations (such as client service and trading optimisation).

As a consequence of the inability to measure absolute risk in monetary terms, Operations Managers are not able to accurately manage the risk, use their resources in the most efficient manner, or add risk value deltas into business cases.

If the Chief Risk Officer or Auditors asked you to quantify the risk you were running, how would you calculate it and even more important, qualify and justify your response?

Why is Corporate Actions processing so risky?

Corporate Actions processing is inherently risky as it sits at the end of a chain of events from trading through to settlement and post settlement. An experienced Corporate Actions analyst needs to understand what happens upstream in order to be able to properly process an event, as well as understanding complex accounting processes and tax implications. There are many moving parts to an event that are outside the control of the Corporate Actions analyst.

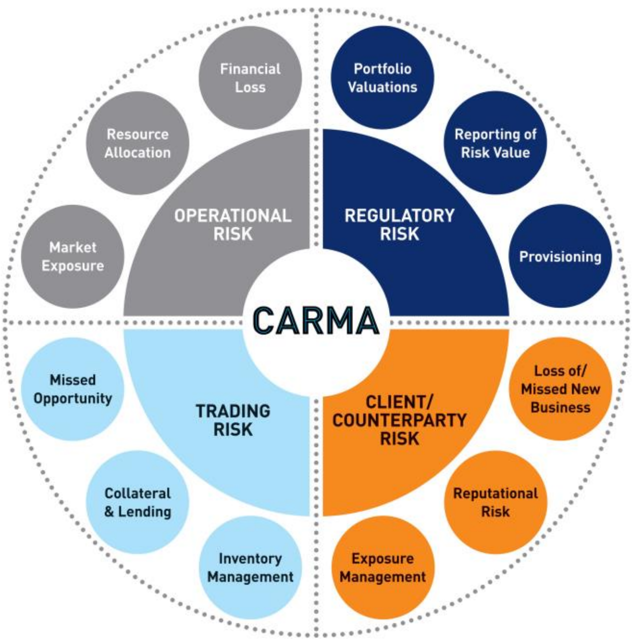
If we look through the event lifecycle of a Corporate Action, there are risk issues at every single stage; from the unstructured / non- standardised announcement process, to multiple position keeping systems, to high volumes of manual notifications and election instructions being generated, received and manually interpreted, through to increasingly complex tax legislation and reporting.

Corporate Actions processing is a highly technical and complex area of Operations that has historically received little support in terms of regulated standardisation or investment in terms of technology solutions.

The processors know there is inherent risk, the Operations Managers know there is risk, the Risk Officers know there is risk – yet as an industry, we are still relying on very poor risk management practices that only provide relative values of risk exposure and not absolute values in monetary terms.

How can we hope to effectively manage the underlying risk in this complex process with such unsophisticated measurement tools in place?

So far, we have only really looked at the Operational issues that can increase risk within Corporate Actions processing. However, there are other risk impacts outside of Operations as well.



The above diagram shows how far reaching the impact of Corporate Actions processing can be across many different areas of an organisation, outside of the obvious Operations specific impact.

The most concerning impact areas outside of the Operations centric / event lifecycle related issues mentioned previously are as follows:

Provisioning : Operations Managers currently have to estimate the amount that should be set aside for provisioning against Corporate Actions' derived losses every year. The most common methodology is a once a year best guess, based on historical loss data. This means that the amount being provisioned does not accurately reflect the current risk profile. Moreover, the amount provisioned does not change as the underlying risk varies over the course of the year.

General Risk Reporting : Whilst the Regulators do not currently require specific reporting for Corporate Actions related risk (it is often tied up in general Operations risk data eg. Client Money reporting), it can't be long until Corporate Actions comes under the regulatory spotlight. Any Operations group that can lose 7 or 8 figure amounts – simply by missing events or incorrectly aggregating and communicating election instructions - must warrant further scrutiny by the various global regulators. As an industry, we are not prepared or equipped to respond to such a request.

Scenario Planning / Forecasting : The current risk valuation models do not allow users to get meaningful data of how the risk profile would be impacted if certain factors were to change. For example, how can users add deltas in risk values resulting from a technology upgrade, or process migration, if only relative risk values are available? This prevents Operations Managers being able to construct accurate business cases that truly reflect the return on investment, as any change in risk exposure cannot be included.

Efficient Resource Allocation : The inability to reflect the true risk value also prevents Operations Managers from using their resources as effectively as possible. The current risk measurement methods only look at the very highest level (usually just the event type) to determine the relative risk. Consequently, an optional event is considered inherently more risky than a choice event, which in turn is viewed as always having more risk than a mandatory event. This is not always the case. For example, a tender offer with a small eligible position is not always riskier than an aggressive rights issue on a highly illiquid stock, or a stock with a large eligible position. This means that Operations Managers do not currently have the information needed to ensure that the riskiest events receive the most attention from the most experienced resources. Effectively, the Ops Managers are not able to manage the riskiest events as they would like to, unless they truly know which events are the riskiest.

The current measurement methodologies do not measure the Operational risk very effectively and completely ignore any risk that is generated outside of the direct Operations impact. Consequently, Operations Managers do not therefore really know where their risk actually lies and therefore are unable to manage it effectively.

In summary, the current methods of risk measurement within the Corporate Actions world are not really fit for purpose. In a world of increasing regulatory focus, how long will it be before the regulators call on the industry to clean up our act and your Chief Risk Officer is asking you why you're not doing it? What if Corporate Actions risk starts to add to the ever increasing collateral burden facing organisations?

Considerably more attention needs to be given to the wider reaching impact of this 'hidden' risk in the process across the organisation as a whole, along with a lower level of analysis of the true risk associated with the Operational process.

We need to get our house in order before the regulators force the issue.

About the author

Adam Stern has been involved in Asset Services since processing his first dividend payment in 1988

Prior to founding Ibacas in 2002, Adam performed a number of Asset Services related roles, from processing, to Ops Management, to Change Management, in both Custody and Investment Banking environments for Citi, Morgan Stanley and ABN Amro.

Since forming Ibacas, Adam has focused on market level initiatives such as ISO standards, Proxy Voting initiative and issuer standardisation. In addition, he has formed excellent relationships with all the major data and software vendors, depositories and industry bodies.

An in depth understanding of Asset Services Operations, upstream and downstream processes, regulatory initiatives, technology improvements and market trends, has allowed Adam to work with many clients to assist with defining their short, medium and long term Asset Services strategies and help them to build the associated business cases to secure funding and buy in across our clients' organisations.

In addition, Adam has led a number of research initiatives such as comparing the levels of process optimisation of Asset Services across the market; methods for measuring the monetary value of Operational Risk in Asset Services; and the benefits and pitfalls of outsourcing Asset Services Operations functions.

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