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Harmonisation of record and ex date: a key standard for cash dividends processing - cost benefits analysis

Introduction

Following the presentation of the European Security Forum's proposal to harmonise ex and record dates for the dividend market, a further analysis was performed in early spring 2005 to identify and quantify the benefits and market wide cost savings that could be achieved by implementing the proposal.

The main focus of the proposal was to reduce costs by minimising the need for market specialisation, and eliminating the need for compensations on pending trades. Responses were gathered from several broker dealers and a custodian, and whilst there are some differences in the benefits foreseen, the average response indicates impressive levels of cost savings.

Analysis

The categories of benefits that were focused on were:

- Savings as a result of process streamlining
- Savings as a result of reduction in seasonal workload
- Savings as a result of reduced cost of carry
- Savings as a result of reduced bad debts
- Regulatory benefits (opportunity loss of market participants)

The benefits initially vary between custodian and broker dealer. Whilst the volume and value of dividends being passed across the books is similar for the two, the causality, and ultimate impact is different.

The custodian will operate a long book scenario, with the majority of the workload being generated by distribution. Dividends are received in from sub custodians (which would indicate timely payment) and are paid on to clients. As such, outstanding payables and receivables are low, and there is minimal pending activity around key dates.

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Conversely, the broker dealer will operate a far more active book, with high levels of trading around key dates, and high levels of payables and receivables which are compensated as a result of dividends not being paid to the appropriate recipient.

Process streamlining

Once the dividend markets are harmonised, the dividend process will have been streamlined across Europe, with the biggest benefit being the eradication of compensations on open/pending trades. As a result of streamlining the process, there should be tangible benefits on the headcount front.

- The average headcount savings from participant firms is 2.83 FTE, with the range varying from 1 FTE to 5 FTE's depending on size of group.
- The cumulative saving across 6 firms is 17FTE, and assuming an average cost of \$150k per FTE, this would represent a saving of \$2.55MM.
- Based on other participant firms that have not yet responded the figure could be extrapolated to \$4.670MM savings across 11 firms.

Seasonal benefits

A significant reason for the amount of additional work around dividend season is the number of compensations (both payables and receivables) that are generated as a result of the record date positions that firms are paid on, bearing no resemblance to their traded entitlement. One of the key benefits of harmonisation is removing the need for compensations on pending trades. The headcount benefits are:

- A total of 8 seasonal heads being saved across 6 firms equating to an average of 1.3 heads per firm.
- Total saving of \$600k assuming a \$75k per head cost.
- Extrapolated savings of \$1.072MM across participating firms.

Compensation activity

In terms of compensation activity across the books and records of participant firms, the number and value of compensations can vary. Custodians report relatively few compensations (1,188 per annum), although this is understandable as pending trades around key dates do not form part of their business model. However, they have higher individual values (\$73k per compensation). Broker dealers have significantly more compensations/claims per annum (anywhere between 20,000 to 300,000) with an average value of between \$5-50k.

Cumulatively, the 6 firms questioned passed 560,000 compensations across their books with a total value of \$1.167bn.

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Cost of carry

Another significant cost of the incorrect distribution of dividends across the industry is the cost of carry of high levels of receivable balances. Dividend receivables represent either a funding cost, or lost investment opportunity. The value of receivables is variable, and across custodians and broker dealers we saw average monthly values of between \$4-5MM. This could represent an annual cost of between \$80-100k assuming a 2% funding rate. Extrapolating this across 11 participant firms would yield an average benefit of \$990k.

Bad debts and write-offs

The high levels of receivables that are carried on firms' balance sheets represent a risk of bad debt. Banks participating in the study reported various levels of write-offs as a result of bad debts, or irreconcilable balances resulting from complex dividend processing. Write-offs ranged from \$10k to \$700k, with an average value of \$275k being reflection of write-offs as a result of dividend activity. However, as a result of the wide variation in values, extrapolation is difficult, but we can safely say that bad debts would be reduced by \$1.5MM per annum across participant firms.

Regulatory benefits

The final area of benefit from harmonisation is the potential reduction in client money balances. Current regulations require that all potential client money is 'locked up' in non-interest bearing accounts to ensure that firms don't benefit from interest earned on monies that are not legally theirs. As a result, there is a lot of 'lost value' in the market. Dividend payables can form a significant portion of client money balances. The value of client money 'protected' ranges from \$12.5MM to \$58MM. This implies a foregone benefit for recipient clients of between \$250k to \$1.16MM assuming a 2% deposit rate. Therefore, significantly reduced payables could lead to a client benefit of over \$3.5MM for the 11 participating firms. Moreover, from a regulatory perspective, it is preferable to have dividends paid to the appropriate recipient.

Conclusions

The total benefit, as per the above estimates, is in the region of \$12MM, and is reflective of 11 firms. If we take the view that the same issues will be experienced across the industry, and across the continent (albeit in varying degrees), it is easy to take the view that the benefits will run into the tens of millions of dollars.

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