A WHITE PAPER FROM FINEXTRA
IN ASSOCIATION WITH BROADRIDGE
SEPTEMBER 2016

LOCAL CUSTODY:
TRANSFORMING YOUR PROXY SERVICE TO DRIVE COST EFFICIENCY AND ENHANCE THE CLIENT EXPERIENCE

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EXECUTIVE SUMMARY

In today's evolving capital markets landscape, local custodians are challenged by regulation, increased competition and margin pressure. In response, they must optimise their operational models for asset servicing in order to take out significant costs, for both domestic and cross-border services.

The proxy process is a prime target for re-engineering because, while it must be performed to the highest standard, it is not in itself a competitive differentiator. So what options do local custodians have to transform the proxy process to reduce cost and risk and improve client service?

This paper sets out to explore the challenges and opportunities for custodians considering adopting a shared service for the end-to-end proxy service, and to suggest next steps for firms to take on the outsourcing journey.

> "You have to look and see where you can drive competitive differentiation. If you can, then it's a strategic process and you keep it inhouse. Otherwise, you look to collective utilities"
> **Tom Casteleyn, BNY Mellon**

02
HEADWINDS

The securities services industry has been a tougher business in which to operate since the financial crisis. Before 2008, life for custodians was pretty good. The volume and value of assets requiring custody was growing, as was investors' appetite to rely on third party administration. Since 2008, the picture has been less rosy. Securities servicers have been challenged by reduced asset values and low interest rates. They have also been faced with a barrage of new regulation, which has been costly and time-consuming to comply with, and which – though it has undoubtedly improved the safety and resilience of the financial industry and increased investor protection – nevertheless imposes an ongoing burden for firms to manage.

Throw into the mix a shake-up of the competitive landscape in Europe driven by Target2-Securities (T2S) – a project which has encouraged central securities depositories (CSDs) and international CSDs to enter the space occupied by custodians, and for which, incidentally, the payback at industry level is not envisaged to kick in until around the 2022/23 mark – and it's not difficult to see why analysts characterise this as a business hampered by "headwinds".

The situation isn't all doom and gloom, of course. There is still demand for operational and administrative services from buy side participants, and the complex regulatory environment presents opportunities for custodians to provide new solutions to help guide their clients through an ever-more challenging landscape. There are also opportunities to exploit digitalisation and data to improve the customer experience and develop compelling

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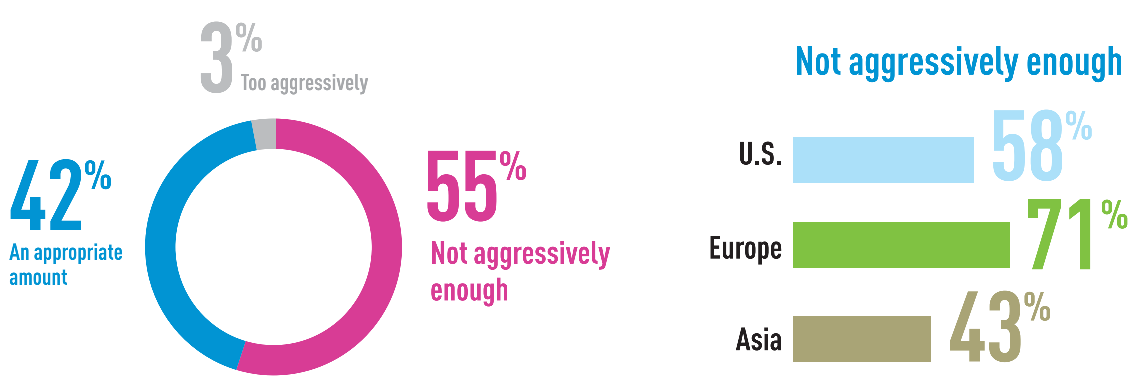
>
> ***Restructuring for Profitability*, Broadridge and Institutional Investor**

capabilities to help retain existing and attract new clients. However, to benefit from these opportunities, custodians must address a major underlying problem – cost bases that are just too high.

In light of the oft-cited ‘return on equity’ (RoE) challenge faced by banks today, the imperative to remove significant structural cost is a strong one. A study carried out by Broadridge in collaboration with Institutional Investor’s custom research unit among almost 150 buy and sell side equity analysts reveals some crucial insights in this context. The findings – published in a report entitled Restructuring for Profitability – show that in the analysts’ view, especially in the US and Europe, cost control and restructuring rather than topline growth and balance sheet management are the best way to address RoE pressure in the coming years.

According to the study, “the main opportunities for cost savings will come from adopting new technology in the back office and middle office, process re-engineering within these functions, and mutualising operations”. How has the industry done so far in reducing costs by these means? Not so well, the analysts suggest: in fact, says the report, during the past five years, banks have “not done enough to deploy technology and re-engineer their operations to become more efficient and recover lost profitability”.

Over the last five years, banks have reengineered their business processes to improve efficiency and margins...



Restructuring for Profitability, Broadridge and Institutional Investor

03
MUTUAL UNDERSTANDING

The importance of leveraging technology to improve efficiency is obviously well understood by custodians. As Tom Casteleyn, Head of Product Management for Custody, Cash and FX at BNY Mellon, says: “What’s happening with T2S for example reflects what is happening overall – a general drive for efficiency and cost reduction. We are automating processes, deploying new technologies like robotics, and implementing constant process improvement through technology and industry standards. And while we are doing that we have to make sure we maintain and improve client service and quality.”

The opportunity to reduce cost through shared services is also well understood. “When everybody is performing the same process, and where it’s not one which can be a competitive differentiator, there is certainly a possibility to centralise it,” Casteleyn says. “You have to look and see where you can drive competitive differentiation. If you can, then it’s a strategic process and you keep it inhouse. Otherwise, you look to collective utilities.”

In the current evolving environment, many custodians are in the process of executing strategies precisely designed to leverage their competitive differentiators. In light of T2S, BNY Mellon will continue to connect directly for settlement in Germany and the Netherlands, and will move to direct settlement in France, Belgium, Italy and eventually Spain. As Casteleyn explains, in Italy, for example, this will mean the bank is re-insourcing asset servicing processes which it has for a long time outsourced to sub-custodians. “We are doing this in markets where we believe we have the volume and where, though there are market specificities, there is enough generality for us to insource. In markets where we don’t have that scale, or which are complex, this wouldn’t make sense.”

In light of T2S custodians are executing strategies designed to leverage their competitive differentiators.

The bank's clients will benefit because BNY Mellon will be "more efficient in those markets", Casteleyn says. "We will give better deadlines to clients, and we can offer a better overall settlement service, as well as increased asset safety and eventually a more efficient cost model where we go direct, because of our systems and scale." Pursuing a local market strategy does not preclude finding value in a utility for certain functions, he adds. "Both global and local utilities can work, and global utilities can have a local flavour," he adds.

Northern Trust too is pursuing a strategy to optimise market access in the T2S environment. "Once we overlaid the harmonisation of settlement brought by T2S with the implications of the CSD Regulation (CSD-R) we realised that together they could be a game changer in the way markets are accessed," says Michael Buzza, Senior Vice President, Market Advocacy & Innovation Research at Northern Trust. The bank's strategy will be to go via the investor CSD Euroclear France to access six markets directly, he adds, and employ Deutsche Bank for asset servicing. "We looked at our already robust sub-custody arrangement and created a plug and play type of model that further optimizes our market access. The investor CSD model gets us closer to the market with our own CSD accounts, increases transparency and, together with settlement in central bank money, will enhance our overall client offering."

In the context of leveraging its competitive strengths, Buzza agrees that "first and foremost... we look for commoditised functions to be carried out in the optimal locations".

04
A VOTE FOR PROXY

A number of areas tend to be mentioned in discussions with custodians about what could be put into a mutualised, shared service, including corporate actions and static client data. One activity performed by custodians which many consider appropriate for re-engineering into a shared service not just at the global level but also locally is the proxy voting process. Far from being unimportant, this proxy process is increasingly under scrutiny as authorities, issuers and investors seek to raise corporate governance standards. Proxy processing, vote confirmation and meeting results now rank among the most important parts of the investor value chain. Institutional investors must practice good stewardship of shareholder money through appropriate diligence and operating principles, and in turn custodians must respond to growing pressure from their institutional investor clients to provide a more efficient service to aid the stewardship of their portfolios. Robust corporate governance practices are needed at the market level in order to attract investment and maintain investor confidence.

In today's world, voting at general meetings is where good issuer and investor corporate governance come together

Current trends in corporate governance include a growing focus on what makes an effective board, with attention particularly being paid to independence, composition, diversity, and board leaders' roles and remuneration. Investors and their advisors are also applying more scrutiny of individual directors, and there is increasing demand in many markets for internal and/or external board and director assessments to drive board performance. In addition, the market is characterised by more regulations, more revisions to corporate governance codes, more rules on disclosure to drive increased transparency, and more shareholder engagement.

Institutional investors attach a growing importance to exercising their entitlements and obligations through meeting participation and voting, and have a heightened focus on portfolio governance risk; corporate issuers have a reciprocal desire to engage more proactively with investors, with a goal of attaining higher levels of buy-in and ultimately attracting increased investment. So in today's world, voting at general meetings is where good issuer and investor corporate governance come together. For this reason, investors are turning to their custodians to provide accurate and timely voting notifications, extended voting windows, and better reporting in regards to valid receipt of voting intentions and meeting outcomes.

The proxy process can be time and cost intensive and must be performed efficiently and to the highest standard. For example, although there is one meeting and one announcement, if every local custodian is providing this information to its clients, this implies considerable duplication of effort – when what every client actually needs is the original announcement as quickly as possible, to give them the maximum amount of time in which to make a voting decision.

In some markets, meeting announcements can appear in newspapers. These must be read every day, the notices must be translated and the announcements sent out – entailing a huge amount of manual activity. The potential to streamline this, to have the activity performed once on behalf of all impacted entities through a scalable, mutualised service, clearly generates an opportunity for cost savings and operational risk reduction. In other markets there are very specific rules governing how meeting announcements must be made, which make it straightforward for all providers to access the information, but for any investor that has relationships with more than one custodian there is an inherent inefficiency in being given the information multiple times and required to vote multiple times. When clients are looking for efficiency and a consolidated view, giving them information that is duplicate and fragmented is clearly not a competitive differentiator.

On the other hand, taking advantage of a managed, mutualised, best in class service for the proxy process – a shared service model that provides at a local market level an end-to-end proxy solution, covering agenda sourcing and translation, distribution of meeting announcements and vote execution – would enable custodians to reduce the cost and complexity of their local operations, streamlining efficiency, minimising errors, improving timeliness and enhancing profitability and growth, while bolstering customer service and reinforcing the firm’s reputation in the market.

When clients are looking for efficiency and a consolidated view, duplicate, fragmented information is not a differentiator

05 CIRCUMVENTING POTENTIAL ROADBLOCKS

The concept of moving to a mutualised, shared service for proxy is not without its challenges for some firms. If a custodian views proxy in the context of its wider corporate actions activity, for which it still must retain people and data sources, it may question the economic sense of outsourcing just one part of the whole.

There could also be concerns around accuracy, security and reliability of the outsourced service – and deploying a shared service for what is a critical function could be perceived as a risky strategy.

Outsourcing the proxy process could also have implications for securities lending activities, and in addition there could be concerns about how a shared service can accommodate specific market nuances – for example markets that require registration/re-registration, power of attorney or physical attendance at meetings.

In light of these possible stumbling blocks, there are certain characteristics a shared proxy voting service should have in order to offset any concerns. These should include a proven track record of providing end-to-end proxy voting services in major markets, with a demonstrable ability to incorporate market specificities, as well as the endorsement of relevant external certifications such as SSAE16 to offer reassurance around security and reliability. "Local custodians considering taking advantage of a shared service for proxy voting should carry out the appropriate due diligence procedures to satisfy themselves of the robustness of the service they are looking at, and its scope," according to Demi Derem, general manager, Investor Communication Solutions International, Broadridge.

Taking advantage of a managed, mutualised, best in class service for the proxy process would enable custodians to reduce the cost and complexity of their local operations, streamlining efficiency, minimising errors, improving timeliness and enhancing profitability and growth.

06
A QUESTION OF TIME

As end-to-end services are more widely adopted, the opportunity for scale economies increases

Creating and delivering a shared service which brings value to the broadest range of market participants is a journey. For example, once an end-to-end proxy voting service is deployed in a given market, the benefits will continue to accrue over a period of time. The service will tend to usher in a new level of automation – and the increasingly electronic process could well lead to the removal of specific manual characteristics which have caused inefficiencies in the past, eliminating obstacles to voting and increasing accuracy and efficiency.

An automated end-to-end proxy voting solution can also improve the availability of information about the process, for example providing to investors status updates pre- and post-voting, confirming that votes are ready to be lodged, have been received and have been accepted and reconciled. Automation also makes it possible to offer longer deadlines.

As end-to-end services are more widely adopted, the opportunity to capitalise on scale economies increases. If a solution is deployed first by a global custodian to underpin its T2S strategy in a given market, it is then available for local providers in that market to exploit. On the other hand, if the solution is being used by local custodians, there are also opportunities for global players to take advantage. In fact, all investors, issuers, global and local custodians could leverage vote confirmation and reporting transparency, and local proxy management could be integrated with cross-border vote processing.

Every additional market participant drives scale, enabling more costs to be eliminated on a firm by firm basis – creating spend that custodians can deploy on genuinely differentiating activities. Shared services also deliver a 'future proofed' offering to firms that leverage them, since the shared service provider will be expected to accommodate future market changes, helping to insulate individual custodians from their impact.

07
BLOCKCHAIN REACTION

When it comes to future proofing, firms should also look to providers of shared services for leadership on the implementation of emerging technologies such as blockchain. Casteleyn at BNY Mellon identifies an opportunity to “use emerging technologies to act as a catalyst for centralisation”, and points out that some of the early proofs of concept of blockchain are in the asset servicing space.

Indeed, the Russian CSD National Settlement Depository has tested an e-proxy voting system running on a distributed ledger, and Nasdaq is using blockchain to streamline proxy voting on companies listed on the US Exchange-held Talinn Stock Exchange. Broadridge, a global leader in proxy processing, has also made public its commitment to blockchain technology, through investment in Digital Asset Holdings alongside many of its clients, and participation in the Hyperledger Project.

As Buzza at Northern Trust says: “By its very nature, blockchain creates a collaborative environment, and the next three to five years will be a very interesting time in terms of where this technology goes.”

08
NEXT STEPS

To determine whether a shared service for the proxy voting process will deliver value to a local custodian, the firm should ask a series of questions to assess the appropriateness of outsourcing.

1. **Evaluate your firm's expertise**. Assess your current capabilities and any developments planned. Look for gaps in light of what you are doing in other markets and in relation to what your clients are asking for. Compare your capabilities to those on offer from shared service providers and ask whether performing this function yourself is delivering you any competitive advantage at the local level. Assess the impact on your operations of outsourcing, and determine whether you could adopt best practices for this critical function. Think about the likely impact of emerging technologies on proxy processing, and ask whether you would be in a better position to leverage these by working with a shared service provider, rather than running your own local proxy process inhouse.
2. **Evaluate your governance and risk management**. What would be the implications of adopting a shared service for the proxy process? What standards would the service need to meet in order to adhere to your requirements for governance and risk management? Where are the gaps in your current environment, and what characteristics would a shared service need to have to fill them?
3. **Evaluate your client services**. Look at how well you are meeting your clients' growing demand for a timely and efficient service today, and at how accurately you are reporting to clients on your activities to execute their preferences as instructed. Could a shared service meet the same standards of client reporting? Are you missing an opportunity to offer ancillary services? Could outsourcing address any gaps in your current capabilities?
4. **Evaluate your costs**. How much are you spending on the proxy process today, and how much would you spend on a shared service? What would be the upfront costs of moving to an outsourced model, and how long would the payback period be? Would you be able to eliminate other costs (personnel, data sourcing et cetera) or would you be carrying parallel costs? Where could you usefully divert any savings from moving to a shared service to support a genuinely differentiating activity at the local level?

09 CONCLUSION

The securities services landscape is evolving, driven by regulation, market change and increasing competition, and the margins in custody provision are under pressure. Given the requirement of investors to exercise their corporate governance responsibilities to the highest standards, the proxy process must be performed impeccably, but does not typically bring competitive advantage to local custodians.

Outsourcing to a shared service provider is therefore a viable option, and banks should look to providers with a proven track record of accommodating market specificities, bringing automation and transparency, and unlocking scale economies – in order to reduce the costs of the proxy process, while maintaining world-class levels of quality and customer service.

> "First and foremost, we look for commoditised functions to be carried out in the optimal locations."
> **Michael Buzza, Northern Trust**

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ABOUT

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– Direct sourcing of meeting announcements and related meeting materials
– Translation of shareholder materials from local language to English
– Execution of vote instructions in local markets through direct delivery of both local and cross-border voting instructions to the CSD, issuer, issuer's agent or registrar

For more information about Broadridge's local proxy management services, please email global@broadridge.com or visit www.broadridge.com/local-proxy

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