



P&I PAYMENT REFINEMENT:  
A MOVE TO FURTHER REDUCE PAYMENT RISK

A WHITE PAPER TO THE INDUSTRY – NOVEMBER 2009



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# 1 . EXECUTIVE SUMMARY

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One of the core asset services provided by The Depository Trust Company (“DTC”), a subsidiary of The Depository Trust & Clearing Corporation (“DTCC”), is the daily collection and allocation of cash entitlements due on DTC-eligible securities. Commonly referred to as Principal and Income payments (“P&I”), these entitlements include dividend, interest, periodic principal, redemption and maturity payments arising from the servicing of 3.5 million securities eligible at the depository.

To facilitate this service, each business day DTC operations staff communicate with agents and issuers regarding entitlements due that day, collect expected payments and allocate entitlements to participants for further credit to beneficial owners. DTC collects and allocates virtually all payments on their scheduled payable date – including those that may be paid to DTC after established intraday cut-off times or received without the detail needed to allow a payment to be paired with its specific CUSIP number.

There are inherent risks associated with allocating late and unidentified payments. After internal review and examination and in-depth discussion with regulators, DTC has determined that, given today’s market conditions, these risks must be substantially eliminated. In response, DTC intends to sunset its current practice and transition to a methodology for allocating only those entitlements paid and identified at a CUSIP level and received by the prescribed cut-off time of 3:00 p.m. (Note: all times cited herein are Eastern Time.) The new methodology will become effective in January 2011. The transition will have an impact on participants and beneficial owners.

This document is intended to prepare participants and agents for the changes in DTC’s P&I collection and allocation practices. To that end, it:

- Describes the current process and inherent risks associated with an “allocate all” methodology.
- Introduces and solicits commentary on DTC’s methodology to “allocate only those entitlements paid and identified at a CUSIP level.”
- Raises awareness of the procedural revisions necessary within all links in the payment chain to support this effort.

## 2. BACKGROUND

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Since shortly after the securities industry's 1996 transformative change to a same-day-funds payment convention for settlement obligations and securities servicing transactions, DTC has employed a methodology that allocates nearly all P&I due each day whether or not the depository has yet received all funds due or the CUSIP-level details.

Thanks to the efforts of paying agents, issuers and DTC, since the implementation of same-day funds, payment timeliness has continued to increase and the transmission of CUSIP-level detail ("confirmations") to support these payments within established cut-off times has improved significantly. While these ongoing processing improvements have enabled DTC to increase allocation of matched payments by 3:00 p.m., significant dollars allocated each day continue to be received after payment cut-off and/or are unable to be matched to CUSIP-level detail until after the payable date. (Note: DTC generally allocates all payments due on the payment date unless agent/issuer information signals that the entitlement will not be funded.)

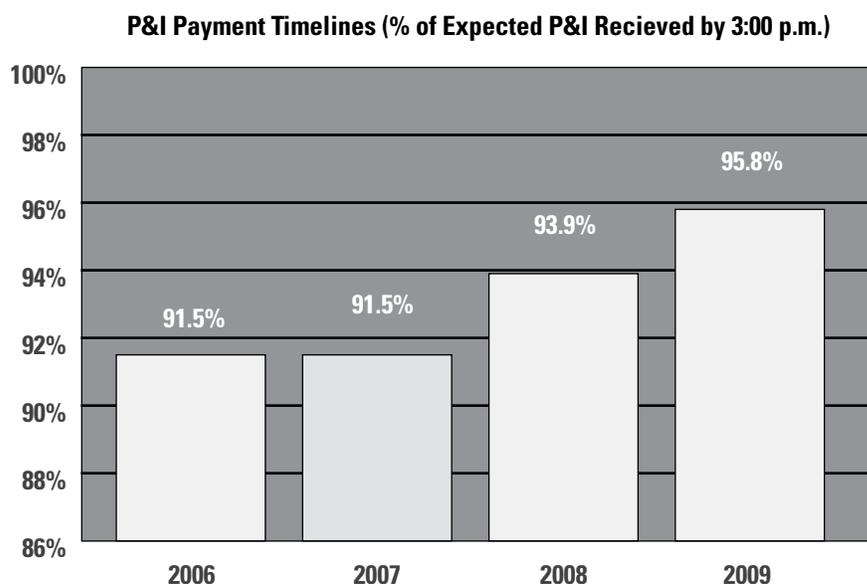
While the practice of allocating all entitlements on the payable date has provided a great deal of certainty for DTC participants and their customers, the exposure to credit and liquidity risk in an increasingly complex financial and regulatory environment has grown to unacceptable levels. With risk mitigation now at the forefront of market participants' and regulators' concerns, DTC has applied its experience to develop a new model for implementing P&I payments. This model addresses the risks inherent in the present system, in which an issuer or agent can fail between the time a payment is allocated and receipt can be confirmed, or a DTC participant can fail between the time a P&I payment is allocated and reconciled.

In this paper, DTC presents its plan to transition the industry from "allocate all" to a model of "allocate only those entitlements paid and identified at a CUSIP level" within appropriate time frames.

### 3. EXISTING OPERATIONAL ARRANGEMENTS

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DTC's Operational Arrangements Necessary for an Issue to Become and Remain Eligible for DTC Services ("OA")<sup>1</sup>, signed and executed by every agent, requires issuers and paying agents to provide payments and provide automated CUSIP-level details to support those payments to DTC by 3:00 p.m. and 2:50 p.m., respectively. To assist paying agents in this effort, the OA further requires issuers to fund their agents by 1:00 p.m. or such earlier time as required by the agent to ensure timely payment and detail notification to DTC. Through the diligence of all parties, payment timeliness – the percentage of payments collected from agents and issuers – has risen over the years, to nearly 96% of expected funds received by 3:00 p.m. Thus far, in 2009, nearly all such payments have been precisely allocated.<sup>2</sup>



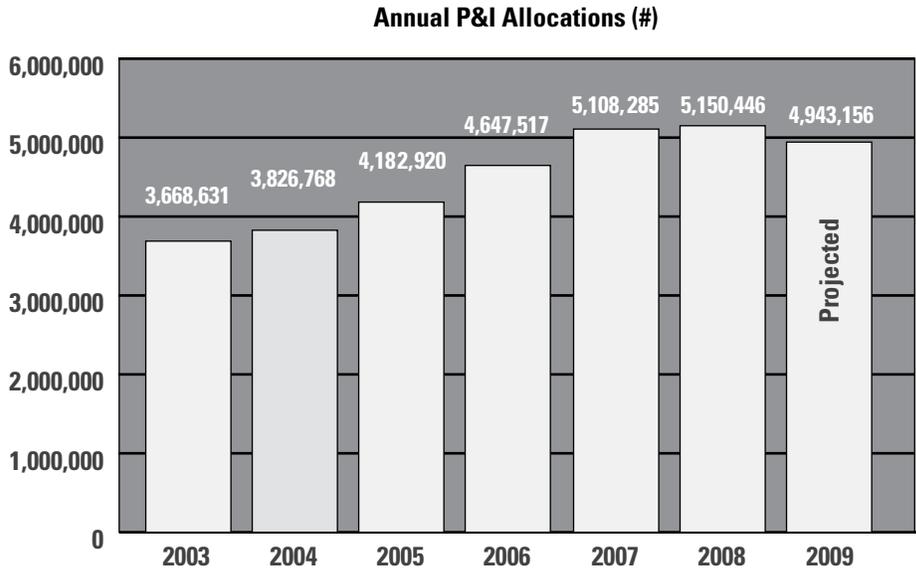
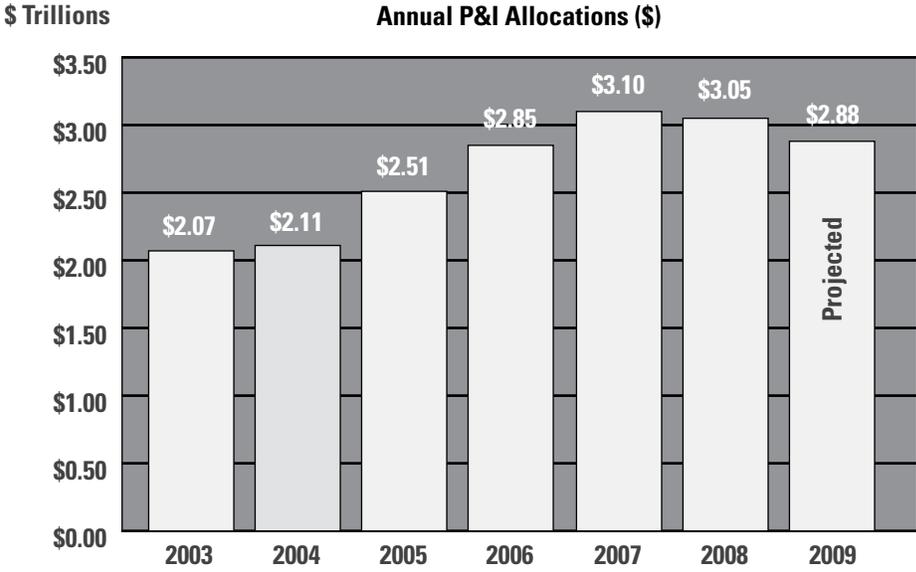
Compliance with OA requirements is critical, given the volume of P&I payments processed on DTC-eligible securities.<sup>3</sup> DTC in 2008 collected and allocated over 5 million payments totaling over \$3 trillion. Thousands of entities were involved, including large bank paying agents, commercial transfer agents and trust companies and, on the issuer side, large and small, corporate and municipal entities. While issuers and their agents are the primary links in the payment chain, many entitlements involve other intermediaries (e.g., servicers, letter of credit banks), and coordination between all entities is critical to ensure payments are processed on a timely basis.

1. DTC's OA is available for download at [http://www.dtcc.com/downloads/legal/rules\\_proc/eligibility/2008-14\\_operational.arrangements.memo.pdf](http://www.dtcc.com/downloads/legal/rules_proc/eligibility/2008-14_operational.arrangements.memo.pdf)

2. Precise allocations are those allocations effected through receipt of payment and corresponding CUSIP-level detail.

3. P&I payments exclude those payments made on Money-Market Instrument (MMI) securities.

In DTC's discussions with paying agents involving late payments (those received after 3:00 p.m.), late issuer releases and the involvement of financial intermediaries are the reasons cited most often for late payments. While most payments are accompanied by automated CUSIP-level detail and are thus allocated in a straight-through manner, a sizable percentage continues to be manually confirmed, resulting in added expense to DTC and paying agents.



## 4. DAILY P&I PROCESSING

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In a typical processing day, DTC collects from issuers and agents and allocates to participants anywhere from 2,000 to 10,000 payments (separate CUSIPs and events) valued between \$2 billion and \$10 billion or more. On peak processing days – the 1st, 15th and 25th of each month – volumes range from 35,000 to 230,000 payments valued in the range of \$35 billion to more than \$70 billion.

Employing the payable-date methodology for allocating P&I entitlements, in 2009 DTC has allocated more than 99.95% of all cash due on the payable date.

The overwhelming percentage of P&I entitlements is allocated to participants during the P&I processing day in a precise manner. Money and corresponding CUSIP-level detail received from issuers and agents are matched and allocated to DTC participants throughout the day. In order to maximize precise allocations, DTC staff continually communicates with agents and reports to its management the funding status, as provided by agents, for unallocated large-dollar entitlements. This information is currently used to support the decision to allocate unfunded payments at cut-off. Payment history for both the agent and CUSIP assists in this decision making.

All payments are allocated to participants during the day, with final allocations occurring by 3:30 p.m. to support the combined DTC/NSCC (National Securities Clearing Corporation) end-of-day cash settlement process. Because not all entitlements are funded to DTC by this time, DTC continues to receive funds from agents and issuers to its concentration bank accounts until Fedwire close. DTC maintains intraday and overnight banking arrangements to support P&I activity.

## 5. RISK CONCERNS WITH THE CURRENT PROCESS

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A recent regulatory review of the P&I process identified risks inherent in DTC's practice of allocating entitlements before receipt from the agent or issuer or without CUSIP-level detail. One such risk is that of a "double default," whereby after an allocation is made, DTC determines that the agent/issuer responsible for the payment never made it, and the participant who received the allocation defaults when DTC attempts to recover it.

Given the extensive progress DTC and agents have made in improving agents' practices in wiring these funds, DTC recommends phasing out the current practice and moving to a methodology that results in allocating only those entitlements paid and identified at a CUSIP level and received by the prescribed cut-off time of 3:00 p.m.

Even with the presently high intraday allocation rates, such a change requires continued improvement to mitigate the impact on participants and beneficial owners. With a 3:00 p.m. cut-off time, the difference between the current 96% performance and 100% compliance could leave sizable dollars unallocated on the payable date. For example, on a peak day where expected allocations total \$50 billion, 96% compliance under the revised methodology would result in approximately \$2 billion not being allocated.

## 6. IMPACT OF NEW METHODOLOGY ON PARTICIPANTS

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Once the new methodology is implemented, late payments and payments received without associated CUSIP-level detail will likely increase the proportion of funds allocated to participants one or more days after, rather than on, payable date. To the extent that DTC has overnight use of unallocated funds, any investment earnings will be refunded to the participants directly impacted by the late allocations through the existing Monthly Refund Program (with supporting CUSIP-level details produced for each participant).

DTC's track record of allocating virtually all funds on payable date has influenced participants' internal procedures. Some participants automatically credit their customers on payable date in anticipation of being funded by DTC, while other participants credit funds to customers only after receiving confirmation from DTC that the allocation has occurred.

Participants are advised to review their current internal procedures and make whatever changes they deem necessary in preparation for the January 2011 change.

DTC today provides participants a variety of tools to enable them to manage P&I cash flow. These include:

- The PBS/PTS SDAR function, which is updated intraday on a real-time basis showing participants the CUSIP-level details and dollar amounts of both allocated and unallocated items.
- P&I Cash Settlement information throughout the business day available via DTC's "CSHSET" file.<sup>4</sup> The following functionality is available:
  - Projected allocation information. Available Monday through Friday at approximately 4:00 a.m., this data provides participants with projected allocations for that day plus the upcoming five business days.
  - Hourly files containing cash allocation information. Generated at approximately 15 minutes after the hour – starting at 10:00 a.m. up until 4:00 p.m. – these seven mutually exclusive files show all P&I cash settlement records.
  - An end-of-day Cash Settlement file, produced at approximately 5:00 p.m. each day, showing all P&I allocation details. This file is a compilation of the hourly files referenced in the previous bullet.
  - Intraday files of non-allocated CUSIPs. At approximately 12:30 p.m., 1:30 p.m. and 2:45 p.m. Monday through Friday, a file is generated containing that pay date's unallocated CUSIPs, including issues in default and those not funded by the agent.
  - End-of-day unallocated information is available each business day at approximately 5:00 p.m.
  - Information regarding payment information received by DTC after settlement cut-off is available each business day at approximately 7:30 p.m.

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4. P&I/Reorganization Cash Settlement (CSHSET) Function User's Guide is available for download at <http://www.dtcc.com/products/documentation/asset/ccf/asset/06cshset.pdf>.

## 7. IMPACT OF NEW METHODOLOGY ON ISSUERS AND PAYING AGENTS

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Issuers and paying agents are urged to review their internal processes to ensure compliance with the OA guidelines for all facets of DTC eligibility requirements, including P&I procedures and cutoff times. Many paying agents have established mutually acceptable procedures and automated interfaces with DTC, such as the use of CCF or MQ to transmit CUSIP-level details balanced to wired funds. Nonetheless, a number of agents still do not make timely payments and/or do not provide CUSIP-level detail in an automated fashion, creating costly reconciliation difficulties whose resolution requires labor-intensive attention at DTC and the agent. Unless these agents make significant changes, their payments will likely not be allocated until after payable date, leading to investor dissatisfaction.

## 8. QUALITY-IMPROVEMENT EFFORTS

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Since 2008, in an effort to raise performance levels, DTC has published performance measures for its Asset Services processes in the form of sigma levels, using a detailed agent scorecard for structured securities. Since the inception of the scorecard, the sigma performance levels in timeliness and accuracy of data submission for structured securities improved so significantly that the highest-volume agents agreed to an industry-wide sigma level target for 2009.

DTC has recently expanded its reporting to all other critical Asset Services processes, including those for underwriting, redemptions, dividend and interest payments, and reorganization announcements. One of the P&I cash processing metrics specifically focuses on agent payment performance by 3:00 p.m. DTC will continue to work with all agents to further improve cash allocation rates.

## 9. ACTION STEPS

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Substantial reductions in payment processing risk require total compliance with OA guidelines for payment timeliness and CUSIP-level detail. Increased efficiencies in entitlement processing by all parties in the payment chain have yielded improved payment timeliness and funds-matching in recent years, with a corresponding decrease in risk. Nonetheless, the current scale of entitlement processing is such that a small percentage of non-compliance translates to significant dollar exposure. While improvement to date has come without regulatory involvement, DTC will seek the regulators' engagement as well as the ongoing cooperation of all parties in the P&I supply chain to ensure beneficial owners continue to receive and are able to reinvest entitlements on the payable date under the proposed P&I allocation methodology.

DTC will maintain its collaboration with paying agents and issuers to identify obstacles and solutions that support full compliance, as well as work with various industry groups to maximize coverage in this space.

Among its action steps, DTC will:

- Form an industry task force to ensure collaboration as this effort moves forward.
- Expand communication of agent payment timeliness to include all agents.
- Seek to provide agents greater access to payments expected by DTC.
- Publish milestones as DTC moves toward implementation.
- Reexamine current processing timelines with an eye toward extending the 3:00 p.m. cut-off to maximize precise allocations and extend the window for participants to withdraw P&I funds prior to final settlement; such withdrawal requests presently cut off at 3:00 p.m. Any examination of the P&I processing schedule must consider the impact on the timely completion of the final settlement process.

Transparency on agent performance, as well as identification and reporting of the impact created by others in the payment chain, will cause all parties to revise processes to improve individual performances. These individual improvements will reflect greater operational efficiencies accruing to agents, DTC and participants.

Corresponding improvement in payment timeliness and submission of balanced CUSIP-level details also reduces inherent risk, and DTC believes the changes outlined above will raise awareness of this risk and the modifications needed to refine the P&I payment process and further reduce payment risk for all parties.

## 10. QUESTIONS AND COMMENTS

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DTC invites and welcomes questions and comments on this matter. Participants can direct questions and comments to their DTC Relationship Managers; agents and issuers can direct questions and comments to John Faith, Vice President, The Depository Trust & Clearing Corporation, 813-470-1100, email: [jfaith@dtcc.com](mailto:jfaith@dtcc.com). If you are interested in participating in the industry task force, please contact the aforementioned parties by January 15, 2010.