Common Standards Are Critical for Depositary Banks to Meet Due Diligence Demands

Increasing emphasis on risk management and asset protection is putting a strain on due diligence processes for depositary banks – leading to time and cost pressures. The key to relieving these pressures lies in establishing a set of common industry standards for due diligence questionnaires, says Susanna Scheffold, global head of securities services at UniCredit

Mounting risk awareness and regulation are seeing due diligence procedures rise up the list of depositary banks' priorities. Yet progress in this regard is being held back by the effort and expense involved in obtaining high-quality information on network relationships. It is therefore increasingly vital for participants to establish common standards in terms of what information is required for depositaries to carry out thorough due diligence.

Such a move promises to quell the rising cost and time pressures associated with gathering relevant data on counterparty risk, while simultaneously generating a substantial improvement in the quality of the information received.

Certainly, now more than ever, due diligence is at the forefront of network managers` minds. Indeed, one of the most notable trends in the securities services market over recent years has been depositary banks´ increasing focus on risk awareness and asset protection. Network managers are turning to every means at their disposal to assess and reduce risk in their investments – with external audits, guarantees and legal opinions featuring ever more regularly in their day-to-day activities.

It's a development that is inextricably intertwined with a fast-advancing regulatory agenda, with the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings for the Collective Investment in Transferable Securities V (UCITS V) together laying out a robust framework for risk management processes.

This risk-aware environment is behind depositaries' increasing concern with the quality of their due diligence procedures – with many now meticulously checking their network relationships to root out and contain risks.

Undue difficulties with due diligence

Yet carrying out these procedures is becoming increasingly difficult – not least because depositaries require more and more information on their network relationships. Due diligence reports now comprise hundreds of pages, packed with all kinds of risk-related data requested by depositaries keen to know the smallest details. Indeed, questions as specific and unexpected as "Are there parking spaces within 10 metres of the building?" are finding their way onto questionnaires, as funds look to cover every angle in assessing counterparty risk profiles.

Of course, these questions differ wildly from depositary to depositary, with each entertaining different ideas about what is important for determining risk. As a result, respondents must approach each due diligence questionnaire anew – with fresh attention and fresh research required to address a different set of questions.

Consequently, due diligence has become an arduous and costly procedure – draining the time and resources of all involved.

Setting the standard

At the root of this problem, then, is a lack of common standards regarding what information is necessary for depositaries to carry out due diligence on their counterparties – and it is by addressing this lack that we can forge a solution.

With common standards defining what information is required from due diligence questionnaires, much of the burden will be relieved. It will no longer be necessary for depositaries to deliberate over what data to request, or for counterparties to carry out regular research to fill in their responses.

Of course, establishing common standards is easier said than done. For a start, the range of data points requested by various participants is incredibly diverse, with reasonable consensus on what information is important.

This is a problem fomented by Europe's regulatory fragmentation – where directives such as AIFMD and UCITS V have reduced, but not yet eliminated variations in terms of approach and understanding.

Of course, in any situation such as this, each participant will want to see its own priorities and preferences reflected in the common standard, while the requirements of others will be seen as an unnecessary distraction. This makes approaching consensus on the matter a considerable challenge.

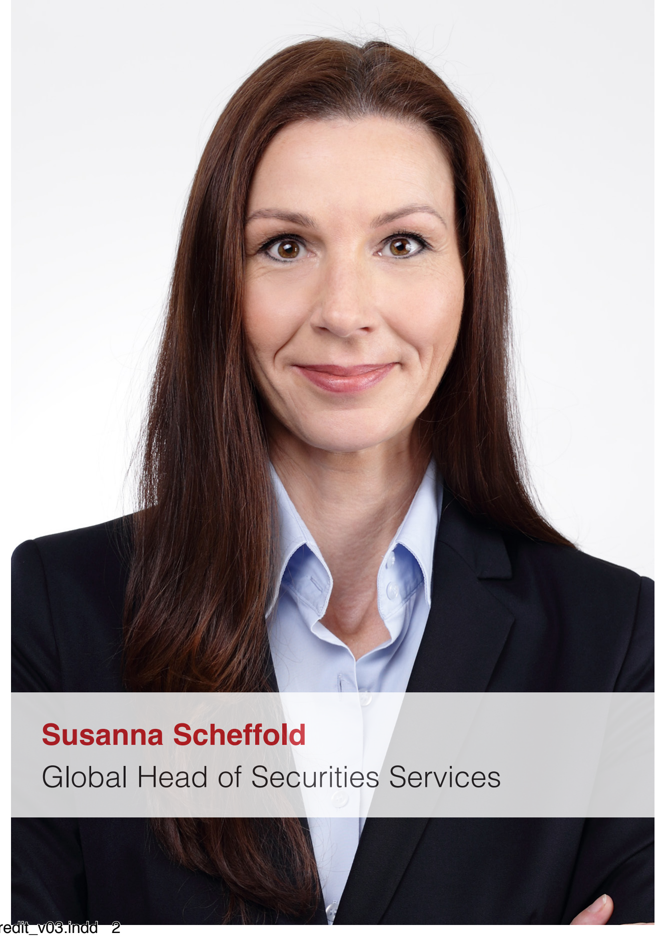
The promise of compromise

Overcoming this challenge will be a matter of compromise. And the first compromise that needs to be made is accepting that full consensus – while desirable – is not completely necessary. Indeed, consensus on around 80 per cent of the requirements would still be of enormous value.

Such an agreement would mean that the majority of relevant information could be researched once and then simply reproduced and checked for future requests – drastically cutting the amount of time and money that needs to be spent on due diligence procedures.

What's more, service providers would even be able to start sending out responses to questionnaires proactively – anticipating their clients' needs and sourcing the relevant data in advance to further accelerate the process.

Better still, these cost and time savings will be accompanied by a significant boost in terms of the quality of the information received. With all market participants aware of the data they are required to provide, the likelihood of errors, misunderstandings and difficulties in obtaining the relevant information will decrease considerably.



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Another step towards harmonized service levels

Common standards will also play well into future technological developments – enabling faster processing times for previously laborious tasks. Indeed, further investment in technology has the potential to harmonize service levels throughout Europe – fuelling greater efficiency while easing cost pressures and other demands on internal resources.

Certainly, developments in market harmonization are highly necessary, and work on such improvements is already under way. Beginning last year, a number of leading depositary banks have been collaborating to create a common due diligence questionnaire in order to rationalize procedures across the industry. Time will tell how successful this initiative is, but market participants would do well to encourage and engage with such efforts.

Of course, while a standardized set of due diligence questions is undoubtedly a valuable first step, depositary banks must follow through with further work. Notably, even with a rationalized process for obtaining data, the analysis of this information still poses a challenge – and network managers will need to find new and effective ways of tackling this challenge if they are to bring the cost and effort of due diligence fully under control.

Moving forward, we can expect continued growth in risk awareness among depositaries, generating continued interest in asset protection and further pressure to maintain high levels of due diligence. Common standards and solutions for the effective gathering and analysis of data therefore have a pivotal role to play in ensuring that depositaries can carry out due diligence to the highest standards, without devoting excessive time and resources to the task.