Adopting a risk intelligent approach to pricing and capital needs for depositaries

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Why is the risk and cost profile changing for depositaries?

Overview

The AIFMD regime introduced a range of new and more prescriptive requirements to harmonise depositary duties across the EU. In July 2014 the Luxembourg regulator, Commission de Surveillance du Secteur Financier (CSSF), published circular 14/587 focusing on UCITS depositaries, which heavily derives from the AIFMD’s provisions and pre-empted the UCITS V obligations.

The main requirements of these regulations include daily monitoring of all cash flows, more frequent reconciliations and verifications, more robust due diligence and risk assessments, stronger segregation requirements and more detailed sub-custody oversight. Underlying these requirements is a change in the standard of liability, which firmly places the burden of proof on the depositary and makes it liable for loss of assets in the first instance.

1 This article is largely based on the white paper ‘AIFMD depositary pricing and capital: Taking a risk intelligent approach’ available for download at http://www2.deloitte.com/luren.html
While depositaries have their own internal operational oversight and due diligence standards, the new regulatory frameworks covering alternative and UCITS funds require that all depositaries invest in operational realignment to varying degrees. In addition to the one-off investment required to align the depositary business with the latest regulatory requirements, increased responsibilities and liabilities have emerged.

It is the changing risk profile associated with the new duties and new liabilities that is likely to affect the depositary cost base and pricing to the greatest extent. Depositaries have sought to negotiate new contractual arrangements with prime brokers to mitigate or transfer this risk but will still be reliant on other parties in order to fulfil key duties.

Operational risks can be addressed through an enhanced control framework or increased automation. However, additional 'residual' risk will remain for depositaries, owing to the increased liability and the new depositary duties that have been defined. The key driver of cost and any increase in depositary pricing is therefore likely to be an individual risk premium based on a client’s specific risk profile, as determined by the depositary.

While there is a diverse and evolving range of practices apparent in the market, we expect depositary pricing to focus increasingly on key risk factors such as contractual arrangements, automated reporting from other parties, network overlap with the prime broker, the location of assets and the complexity of arrangements/number of parties involved, for instance.

**Depositary To Do List:**
- Implement new cash flow monitoring requirements
- Implement new oversight controls on subs/reds accounts
- Implement new prime broker sub-custody reporting arrangements
- Ensure new asset segregation and reconciliation requirements are met at sub-custody level
- Implement new ownership verification and record keeping requirements and be able to produce a real-time inventory of OTC positions
- Increase due diligence and compliance monitoring of sub-custodians
- Increase monitoring of income distribution
- Monitor timeliness of settlements
- Increase frequency of valuation verifications
- Conduct a risk assessment of the AIF strategy and the AIFM organisation
- Implement look through on safe-keeping of financial instruments in custody
- Take action to mitigate liability risk

*Only applicable under AIFMD*
Depositary liability

Under the new regulations, the depositary acts as a quasi-insurer for financial instruments held in custody. If such an asset is lost, the depositary will need to make the fund whole without ‘undue delay’. For ‘other assets’ that by their nature cannot be held in custody, the depositary is subject to a best efforts ‘negligence’ standard. Strict liability aside, depositaries face increased liability due to the risk of an error or breach in relation to the new range of more prescriptive duties they must fulfil. In addition, even for these non-custody assets, the bar has been raised via the imposition of new duties related to record-keeping and ownership verification.

Figure 1: Financial instruments subject to the new liability

<table>
<thead>
<tr>
<th>Financial instruments in custody</th>
<th>Other assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Transferable securities</td>
<td>• OTC derivatives</td>
</tr>
<tr>
<td>• Money market instruments</td>
<td>• Fund units (if held in the name of the AIF by a registrar)</td>
</tr>
<tr>
<td>• Fund units (if registered in the name of the depositary)</td>
<td>• Cash deposits</td>
</tr>
<tr>
<td>• Financial instruments registered or held in an account directly or indirectly in the name of the depositary</td>
<td>• Private equity direct investments</td>
</tr>
</tbody>
</table>

New liability standard

Negligence standard

The depositary is liable for the loss of financial instruments held by both affiliated and unaffiliated sub-custodians. When under AIFMD a discharge of liability subject to strict conditions exists, CSSF 14/587 and UCITS V do not allow for any exception. Fraud, accounting errors, operational failures and failure to apply asset segregation requirements all count as ‘internal events’ falling under strict liability.

The depositary remains liable for financial instruments held in custody that are passed from the Alternative Investment Fund (AIF) or UCITS to the prime broker, even though operationally it has no line of sight into the prime broker sub-custody network. All of these changes present significant operational oversight challenges and imply a change in the risk dynamic and, consequently, in the cost profile for depositaries.
Identifying risk factors and adopting the right response

The increase in depositary requirements under AIFMD, CSSF 14/587 and UCITS V calls for sound risk management approaches to properly identify, assess, manage, monitor and report the various types of risk faced by depositaries (operational, regulatory, financial, counterparty and reputational).

The changes in risk profile can take various forms:
- New risks arising from new regulatory requirements and the consequential operational changes, e.g. new cash monitoring duties
- Increased exposure to pre-existing risks, e.g. increased liability for loss of financial instruments held in custody
- Modification of how existing risks can materialise, i.e. the event(s) leading to the occurrence of the risk differ due to revised operating models.
- For instance, depositaries might have to adapt monitoring processes with respect to cash movements for private equity or real estate funds

Aligning risk responses with business strategy
Each depositary is expected to address the development of an AIFMD-compliant model differently. Responses can take various forms that can be categorised into four types – accept, mitigate, transfer or avoid – according to leading Enterprise Risk Management (ERM) frameworks such as ISO310003, COSO-ERM4 and Deloitte’s Risk Intelligence™ 5.

<table>
<thead>
<tr>
<th>Response</th>
<th>Definition</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk acceptance</td>
<td>Deciding not to change the current situation and accept the risk exposure as it is considered to fall within the company’s risk tolerance. Acceptance entails no specific action, but also does not permit modification of the risk exposure</td>
<td>• Business as usual</td>
</tr>
<tr>
<td>Risk mitigation</td>
<td>Reducing the probability of occurrence or impact of a risk (or both) below an acceptable threshold. This is typically achieved through the improvement of existing controls or the addition of new controls. Mitigation may also include contingency, in the event that the risk still arises (e.g. the business continuity plan)</td>
<td>• Enhanced control environment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Enhanced capital buffer</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Increased use of internal depository network</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Pricing strategy</td>
</tr>
<tr>
<td>Risk transfer</td>
<td>Shifting the threat of impact and ownership of response to a third party, by way of a contractual agreement between the two parties, typically through insurance policies or indemnification or risk transfer pricing</td>
<td>• Contractual arrangements</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Extension of insurance policies</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Pricing strategy</td>
</tr>
<tr>
<td>Risk avoidance</td>
<td>Eliminating the risk, or protecting the business activities from its impact, e.g. via a restriction of products or activities</td>
<td>• Complete market exit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Withdrawal from high risk sectors/markets</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Avoid certain clients</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Avoid dealing with certain third parties</td>
</tr>
</tbody>
</table>

Figure 2: Risk responses

3  www.iso.org/iso/home/standards/iso31000.html
4  www.coso.org/-erm.html
5  www2.deloitte.com/global/en/services/risk.html
There is no ‘one-size-fits-all’ solution. Responses are dependent on depositary-specific circumstances (e.g. the selected operating model) and strategic implications (e.g. the desired market positioning in the UCITS and alternative investment industry). Key questions need to be addressed at board level so that the resulting risk profile remains within an acceptable risk tolerance for the organisation. In practice, it is possible that certain depositaries will be willing to work outside of these target parameters if the commercial considerations on a client specific circumstance require it.

The board will need to consider the wide range of factors arising from changes dictated by the new wave of regulations when determining risk response strategies. Depositaries with limited exposure to AIFs and/or UCITS or with a book of relatively low risk securities could accept the risks as not material. Acceptance of risks may also be particularly desirable for organisations with greater risk-taking capacities or a higher level of risk tolerance. Depositaries that intend to maintain or build a significant presence in the fund market need to consider risk mitigation and risk transfer responses. These measures may include enhancing the control environment and/or adding further capital buffer (mitigate) as well as enhancing insurance cover, contractual structuring and/or adjusting the pricing strategy (transfer).

Responses will require an operational realignment in a way that maximises efficiencies and effectively manages risk in such a way that the business can maintain the optimum level of capital and competitive pricing. Developing the optimum target operating model is challenging and is typically achieved through a number of stages involving first stabilising, then optimising and finally transforming the business structure.

**Key risk factors for depositaries**

Depositaries need to map out all of the risk factors relevant to their business that arise from changes occurring under AIFMD, CSSF 14/587 and UCITS V.

The requirements of the aforementioned regulations are closely aligned and so are the associated risks. In 2014, Deloitte conducted a survey of 14 major European depositaries on the pricing and capital impact of AIFMD. Results indicated that almost half of depositaries rank interaction with their prime broker as their main concern, followed by contractual arrangements, reliance on other parties and system reporting.

![Figure 3: Main AIFMD depositary concerns](image-url)

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6 See ‘AIFMD depositary pricing and capital: Taking a risk intelligent approach’, available for download at www2.deloitte.com/lu/en.html
Prime broker and any third party custodian oversight demands a significant enhancement of the depositary procedures and allocation of resources. The risk of potential liability for assets that cannot be identified within the prime broker’s network and more generally throughout the safekeeping chain must not be neglected.

The depositaries are therefore conducting additional due diligence on prime brokers, which in worst case scenario could result in a refusal to on-board a prime broker.

The increased oversight and reporting requirements also elevate the depositaries’ requests for information from prime brokers and other parties (e.g. collateral agents, clearing brokers, administrative agents).

Reliance on other parties for information presents a major challenge for depositaries, in particular when other entities fail to supply the key data. Cash flow information is one of the examples where operational risk and challenges in receiving the information in a certain format, at a certain frequency and by a certain deadline imposes a considerable degree of risk.

Reliance on administrators within the group might pose fewer difficulties. It is therefore key to apply adequate contractual framework as well as operational flows and define an escalation process to allow for mitigation of these risks. System reporting is also of concern to depositaries, due to the operational realignment involved and risks presented by a lack of automated reporting, including the proliferation of manual processes subject to more frequent errors.

Other issues identified in our survey which are causing concern for depositaries include the application of segregation arrangements, operating in frontier markets (where segregation may be less developed), the number of prime brokers involved (risk multiplication factor and cost/benefit ratio of on-boarding certain prime brokers) as well as the extent to which there is no network overlap. For the latter reason, depositaries prefer to deal with familiar parties or entities within their group. Depositaries will need to build such concerns into their risk profile, pricing and capital models in order to effectively manage risk.
Pricing strategy

Price factors

Custody and depositary fees are frequently set on a volume-basis offering low margins. This may not be commensurate with the level of financial risk exposure transferred to depositaries through increased liability and operational oversight, introduced by recent and forthcoming regulations. A potential misalignment of risk exposure and commercial incentives could have serious implications for a depositary, whose client base could become higher risk over time as prospective clients seek out the most competitive offering. On the other hand, clients with lower risk assets and custody arrangements will expect a fair price and justification for any price increase.

The way forward is through risk-adjusted pricing, based on individualised scoring in relation to a range of pre-determined risk factors, similar to the premium paid for insurance policies. While risk-based pricing is widespread in the credit activities of banks and in insurance policies, this kind of approach is less common in fee-driven businesses such as depositary services. Yet regulators increasingly expect institutions to adopt a risk-sensitive pricing mechanism that serves as an incentive to effectively allocate their financial resources in accordance with their risk tolerance and the principles of sound and prudent business management. The implementation of AIFMD is indicative of a trend towards risk-based pricing, as depositaries have sought to alert stakeholders to the cost impacts of the changing requirements. However, these assertions have rarely included quantifiable evidence.

Depositary pricing could be influenced by three different drivers:

1. **Operational costs:** almost all depositaries needed to upgrade their existing capabilities to respond to new requirements, albeit to varying degrees. A certain amount of the operational and control realignment will include one-off investment costs that will not be recoverable from clients. These might include IT systems development or process re-engineering. Other recurring costs related to AIFMD and/or UCITS V, such as increased headcount or new activities will likely need to be considered in future pricing, given that business costs have increased. Our 2014 survey indicates that 85% of depositaries have increased (or plan to increase) their headcount as a result of AIFMD.

2. **Risk premium:** Depositaries should expect additional return where this involves taking on higher risks, whatever their nature. In classical risk models (such as those applied for credit risk), this additional risk is captured through the notion of ‘expected loss’. Depositaries may need to build a range of factors into their pricing to adequately capture the risk premium. Further work may need to be done in this area as 62% of the depositaries we surveyed are developing a new pricing matrix to address liability and risk post AIFMD.

3. **Cost of capital:** The additional capital allocated to cover risks borne via the increased liabilities of the depositaries (equivalent to the notion of unexpected loss in credit risk models) implies a target rate of return that should be equivalent to what could have been earned if the depositary had chosen another investment with equivalent risk (i.e. the opportunity cost). In some cases, depositaries may need to bolster their capital reserves to cover the additional level of risk. Our 2014 survey suggests that over 60% of depositaries consider that AIFMD requirements impact on their internal capital requirements.

Figure 5:

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes (%)</th>
<th>No (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you plan to increase headcount as a result of AIFMD?</td>
<td>85</td>
<td>15</td>
</tr>
<tr>
<td>Have you developed a pricing matrix to take account of the new standard of depositary liability?</td>
<td>62</td>
<td>38</td>
</tr>
<tr>
<td>Do you consider that AIFMD depositary requirements impact your internal capital requirements to cover risks?</td>
<td>62</td>
<td>38</td>
</tr>
</tbody>
</table>
Commercial reality

Fully embedding all three elements (operational, risk and capital) into depositary pricing might not be entirely feasible for commercial reasons, combined with the complicated and difficult job of actually measuring risk premium and the level of capital to put aside for covering additional risk.

Indeed, the lack of historical experience and market quantification standards makes the calculation and pricing of this risk a challenging exercise. Currently, modelling the increased risk profile, capital needs and impact on price remains highly subjective and is still at experimental stage.

A diverse range of pricing practices and methodologies is apparent across the depositary industry. Survey respondents most frequently indicated contractual agreements, automated reporting, network overlap and number of prime brokers as factors they take into account in pricing, if they have developed a risk-adjusted pricing model in the first place. Other pricing factors cited include jurisdiction of the assets, type of assets, credit risk and whether the entity is affiliated.

Many of the factors clearly indicate a need to price risk sensitively when it comes to prime broker interaction. However, depositaries are mindful of the operational challenges regulation such as AIFMD creates for prime broker models. Thus, from a commercial perspective, depositaries are not generally seeking to drive operational change through pricing but rather through ongoing dialogue.

As a consequence, it is unlikely that new pricing strategy adopted by depositaries will encompass all three price drivers. This is especially true since many asset managers and management companies consider that the so-called depositary risks are actually existing risks that, while increasing with greater liability, should nonetheless already be compensated for by the existing control environment. By far the most impacting factor on the depositary fee adjustment cited in our 2014 survey was the additional risk premium (55%), followed by operational costs (36%), while only 9% plan to include increased capital costs in their AIFMD pricing.

Figure 6: Risk adjusted pricing (illustrative)
Risk intelligent pricing

While a great range of different practices and methods are observed in the industry, we advocate adopting a risk-intelligent approach to deriving the risk premium based on a set of key risk factors to differentiate the price applied to different funds.

The approach is illustrated in the diagram ‘Calculating risk premium’: once relevant factors have been identified (step 1), risk factors are given a particular risk weighting (such as low, medium, high) to reflect the extent to which the client set-up exposes the depositary to errors or losses and the resultant financial exposure (step 2). Assessments of the risk factors are then aggregated to obtain an individual ‘risk score’ for each client (step 3). Finally this risk score is mapped against the level of maximum acceptable risk premium, so as to apply a price that will reflect the particular risk exposure implied by the operational set-up (step 4).

In the illustrative case presented in the diagram, the lack of automated reporting could be seen as a clear threat to a depositary, as it increases the likelihood of errors on a daily or weekly basis. The absence of automated reporting would therefore trigger a ‘high risk’ assessment for that particular risk factor.

Aside from sound risk management, this approach to depositary pricing will assist in raising awareness among sales functions of the critical risk factors that the depositary needs to address and will provide supporting evidence for justifying higher prices, where warranted by operational arrangements.

The methodology presented intentionally uses the notion of ‘maximum acceptable risk premium’, as it is evident that competition and market pressure play a central role in setting depositary fees.

Figure 7: Key depositary risk pricing factors

Source: Deloitte AIFMD depositary survey, based on percentage of respondents
Figure 8: Calculating risk premiums: Deloitte’s view

1. Representative risk factors (not exhaustive)
   - Number of prime brokers
   - Contractual arrangements
   - Jurisdiction of assets
   - Type of assets
   - Credit risk
   - Segregation arrangements
   - Unaffiliated entity
   - Network overlap
   - Automated reporting

2. Assessment for a given client (illustrative)
   - Multiple, but well known
   - Adequately designed
   - Some frontier markets
   - Medium complexity
   - High quality
   - Full segregation
   - Low
   - Low
   - Not automated

3. Overall risk score (Simple or weighted average)
   - Percentage of maximum acceptable risk premium to be applied
   - 0% 20% 40% 60% 80% 100%

Operational synergies

Large multinational institutions offering integrated solutions encompassing sub-custody and depositary services, affiliated prime brokers, fund administration, transfer agency services, cash management and corporate administration are best placed to offer lower pricing due to operational synergies across the group. At the other end of the spectrum, niche players in sectors such as real estate and private equity might also gain market share through aggressive pricing due to lower capital and operational costs from servicing non-custody assets only. Depositaries planning to increase price to reflect the impact of the modified risk profile on operating expenses and their capital base need also to reflect commercial realities and benchmark this decision against the competition and observed market practices.
Capturing AIFMD within internal capital requirements

Overview
Capital serves as a loss absorbency buffer for larger than anticipated (or unexpected) losses, as well as to fund the ongoing activities of the institution. The level of capital is a crucial market indicator for potential investors as well as rating agencies and other interested parties (including the general public). As a consequence, most financial institutions are required by their regulators to hold minimum amounts of capital. Banks and investment firms in particular are subject to the Basel framework transposed into the EU legislative framework through the Capital Requirements Directive (CRD).

The Basel/CRD framework requires institutions to hold a statutory minimum amount of capital to cover three types of risks:

- Credit risk
- Market risk
- Operational risk

Aside from the minimum capital requirements imposed by regulators (also called ‘Pillar I measures’), institutions are also requested to perform a regular internal assessment of the amount of capital they need to hold to cover all the risks they face or could face.

The assessment therefore extends beyond the three types of risks listed above. This process, called the Internal Capital Adequacy Assessment Process (ICAAP), is forward looking and should encompass the expected evolution of activities and associated risks over the business plan cycle. The ICAAP is expected to paint a complete picture of the financial institution’s risk profile. The senior management reviews this profile at least once a year and the board of directors approves the ICAAP report before submission to the competent authority for review.
Depositary risks and the Basel/CRD framework

There is a market consensus that depositary liability is best viewed in the context of operational risk, given the broad oversight responsibilities inherent in the new framework. A failure concerning one of the key new requirements relating to either safekeeping, oversight or cash monitoring would be of an operational nature, i.e. lack of adequate processes to ensure these obligations are met.

Depositary liability would therefore be covered by an operational risk capital charge under the CRD regime and subject to Pillar I minimum requirements. Among the three approaches available to calculate these regulatory minimum requirements, the two simpler methods (the Basic Indicator Approach and the Standardised Approach) are solely driven by the institution’s gross income and as a result do not reflect the specific operational risk profile of the institution. Only the Advanced Measurement Approach (AMA), based on internally developed models, is expected to offer sufficient granularity to reflect the impact of new regulation on the regulatory own funds requirements to cover operational risk.

However, this does not mean that only AMA institutions should be concerned about the capital implications of AIFMD. As seen above, new risks arising from changing regulatory requirements should be reflected in the ICAAP calculation, thereby impacting all depositaries subject to CRD.

Assessing the internal capital needed to cover increased operational risk exposures borne by AIFMD calls for an update and review of current operational risk and control mapping as well as of the stress test scenario analysis in place.
The delta method: Pre- and post-AIFMD assessment

Operational risks related to the depositary function are clearly nothing new. An intuitive approach to assessing the impact of new AIFMD and/or UCITS V could work as follows: the operational risk profile would be assessed before and after application of the new rules (taking into account additional mitigation techniques such as strengthened controls for instance). If significant, the difference could be translated into dedicated additional capital needs. This approach is referred to as the delta method since it focuses on the variation or ‘delta’ of the operational risk profile when considering increased responsibilities under AIFMD/UCITS V.

The delta method is divided into three steps (also see the diagram below):

- Identify operational risk event types that can be considered relevant from an AIFMD/UCITS V perspective
- Assess the impact of new requirements on both the likelihood of a given scenario occurring and the potential economic impact in case of such an occurrence
- Aggregate results and compare pre- and post-new regulations of internal capital requirement estimates

This approach requires the depositary to have an existing set of identified (and, ideally, quantified) operational risk scenarios to act as a starting point

New risks arising from changing regulatory requirements should be reflected in the ICAAP calculation, thereby impacting all depositaries subject to CRD
Step 1: Identification
The first step is to identify which of the seven operational risk event types defined by the Basel Committee may be impacted by the new requirements. For instance, external fraud is evidently a factor to be considered from a depositary liability perspective, while employment practices and workplace safety would not be impacted by new rules under AIFMD or UCITS V.

Most of these scenarios do not actually relate to ‘new’ risk exposures but rather to ‘increased’ risk exposures. For instance, failure of a sub-custodian is not a new risk faced by depositaries, but the obligation to return assets ‘without undue delay’ to clients and the reversal of the burden of proof in the event of an issue lead to an overall increase in exposure to possible losses, penalties and charges. Consequently, there is an increased likelihood of an advance pay-out and the incident having greater economic impact resulting from dispute costs, inflation, market price fluctuations etc.

Step 2: Assessment
The second step involves undertaking an assessment of relevant risk scenarios and should account for management actions and new mitigation techniques, such as new or modified controls, implemented to address new requirements. This means that various end results are possible, including no change to the net risk profile if additional controls neutralise additional risk exposure.

In the ‘sub-custodian failure’ case described above, the impact on model parameters could be considered as follows:
- The likelihood that a failure of a sub-custodian results in an obligation to pay client claims increases
- The total economic impact of the scenario, including an advance pay-out and amplification of the impact due to dispute costs, inflation, market price fluctuations etc., is considered greater than previously

Quantification of the selected scenarios should then be performed by applying the classical frequency/severity model widely used in the financial sector. In smaller or less complex organisations, such modelling techniques might not be available to adequately quantify those scenarios. We believe that even with simpler approaches, this exercise remains a worthwhile contribution to an improved risk management process. Indeed, the key objective is for the outcome to be directionally correct, transparent to all stakeholders and consistent with regulatory requirements.

Step 3: Comparison
Whichever model is deployed, the last step of the process consists of comparing the outcome of the ‘pre-AIFMD/UCITS V’ assessment with the ‘post-AIFMD/UCITS V’ situation. The difference between both cases will form the basis for assessing the impact of new regulation on capital adequacy.

Weaker internal controls would also lead to expanded capital needs, but to a much lesser degree than the operating model.
A Deloitte study\(^7\) illustrated this concept for AIFMD with a fictive case of a typical EU depository bank, based on operational risk data gathered by the Basel Committee, the ORX consortium, Pillar III disclosures and internal experiences. Key metrics of this fictive depositary reflected a realistic order of magnitude observed among market participants.

Based on this initial set-up, the loss event types that were identified as ‘relevant’ for AIFMD are analysed and the impact on both frequency and severity is estimated. This impact is dependent on at least two key dimensions: (i) the degree of sub-custodian network integration and (ii) the strengthening of the internal control framework.

Simulations indicate a potential increase of capital requirements ranging from 30% to 38% for a moderately integrated depositary bank. Such an increase of internal capital needs for operational risk could prove to be problematic, especially in institutions with a limited capital surplus.

This is particularly true for depositaries with limited sub-custodian network integration as our results indicate a high sensitivity to the operating model, with a potential increase in capital needs exceeding 70%. Weaker internal controls would also lead to expanded capital needs, but to a much lesser degree than the operating model, with an estimated increase of 4% to 9% in capital needs depending on the case.

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7  ‘AIFMD depositary pricing and capital: taking a risk intelligent approach’, available for download on www.deloitte.lu.
Conclusion

European depositaries face an increased cost and risk profile as a result of AIFMD, UCITS V and, at the level of Luxembourg, of CSSF 14/587. Inevitably, some of these costs will be passed on to clients through pricing. Risk will be the biggest factor in determining pricing, followed by operational costs, while the capital impact on the price could be very limited.

The scale of the price increase should depend on a range of risk factors and depositaries need to develop more risk-sensitive pricing mechanisms to address this development.

Pricing must take into account a range of risk factors, which could expose depositaries to financial loss. These risk factors need to be weighted in importance in alignment with the organisation’s risk appetite/policy. Each client needs to be assessed via the pricing model to give an accurate risk score and price. Failure to implement such a pricing model could lead to significant future losses and exposure to a riskier client base over the longer term.

Ongoing operational costs will also likely be reflected in the depositary pricing model to some extent, depending on the level of automation achieved and the increase in overheads such as staffing costs. Depositaries may only be willing to work with fund administrators within their group or may need to price more risk sensitively for conducting duties such as cash monitoring.

The issues in the centre of depositary attention are linked to reliance on other parties for information, segregation and safekeeping of assets. Oversight on these entities should be performed via initial and recurrent due diligence, setting up of dedicated agreements describing the roles and responsibilities of each party, putting in place KPIs/KRIs allowing for appreciate monitoring and defining an escalation process involving the fund management company (UCITS V mandatory requirement).

Depositaries’ main concern, however, is how to fulfil obligations for in-custody financial assets held with prime broker or third party custodian and the associated operation of liability. UCITS V does not foresee a discharge of this liability, therefore many depositaries would strive to achieve an operational solution based on greater network integration over the longer term.

Combined with other regulatory initiatives (UCITS VI, EMIR, Target2 Securities, CSDR, MiFID II) focusing on custody/depository services, clearing, settlement and reporting, further operational solutions that enhance data flows and mitigate risk will develop over time. Operational integration and the provision of data solutions are undoubtedly the business challenges but also the opportunities of the future.
Depositaries need to focus more on risk-adjusted pricing, based on individualised scoring in relation to a range of pre-determined risk factors.