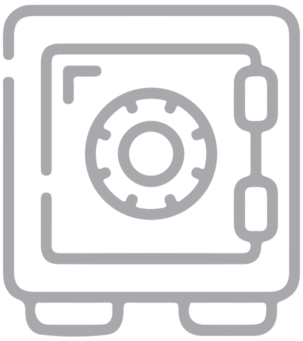
Breaking Down the Barriers to Fund Depositary Digitalisation

Low-code, low-stress, low-cost: Depositary services go digital

1. The Depositary's Context: Pain Points and Pain-Killers



The operational demands on fund **depositaries** have never been heavier. Investors, portfolio managers and fund boards are requiring increasingly granular asset-specific data, and regulatory reporting is becoming much more burdensome. Meanwhile, experienced staff are difficult – and costly - to recruit and retain.

For third-party depositary service providers, **digitalisation** can reduce those costs, cut overall fund expenses, and minimise the risk of supervisory action for late or inaccurate reporting.

This paper examines the pain points faced by depositary heads and their teams, and the impact on their stakeholders. It looks at how digitalisation can be a painkiller. It sets out **best practice to implement a digitalisation programme**, enhancing the capabilities of your in-house back-office staff to focus on growing your business and enriching data collection, confirmation and timely reporting. We also explore the human elements of digitalisation. Change is hard; digitalisation projects can seem daunting, complex and full of risk. Senior managers are wary of cost overruns, poor implementation, and pushback from staff who may see technology as a threat rather than an enabler.

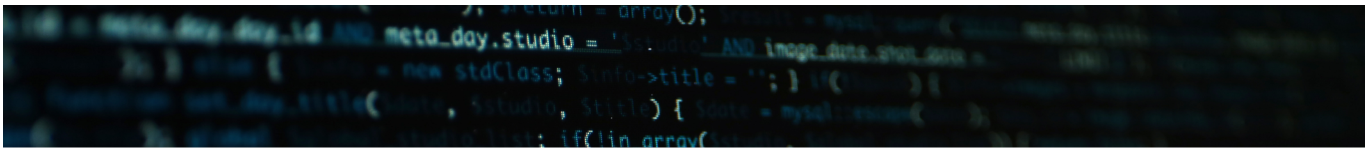
Those fears can be addressed by ensuring there is a shared overall vision and ambition to "**go digital**", business and IT teams are aligned, and technology is explained as friend, not foe.

WHAT A DEPOSITARY DOES

Luxembourg's fund industry has more than €5trn in assets under management, according to regulator CSSF, which require safekeeping by a regulated independent depositary. By law, a depositary must undertake the following functions:

- **Launch and onboarding** - Risk assessment of constitutional documents
- **Cash flow monitoring** - Review, reconciliation and oversight of transaction settlement
- **Safekeeping of assets** - Ownership and existence checks, record-keeping
- **Oversight** - Asset sales, issue, repurchase and redemption

  - AIFM due diligence, NAV methodology and procedures
- **Compliance and reporting** - Regulatory compliance and quarterly reporting to a fund's AIFM



2. The Depositary's Challenge: Regulation, Experience and Expertise

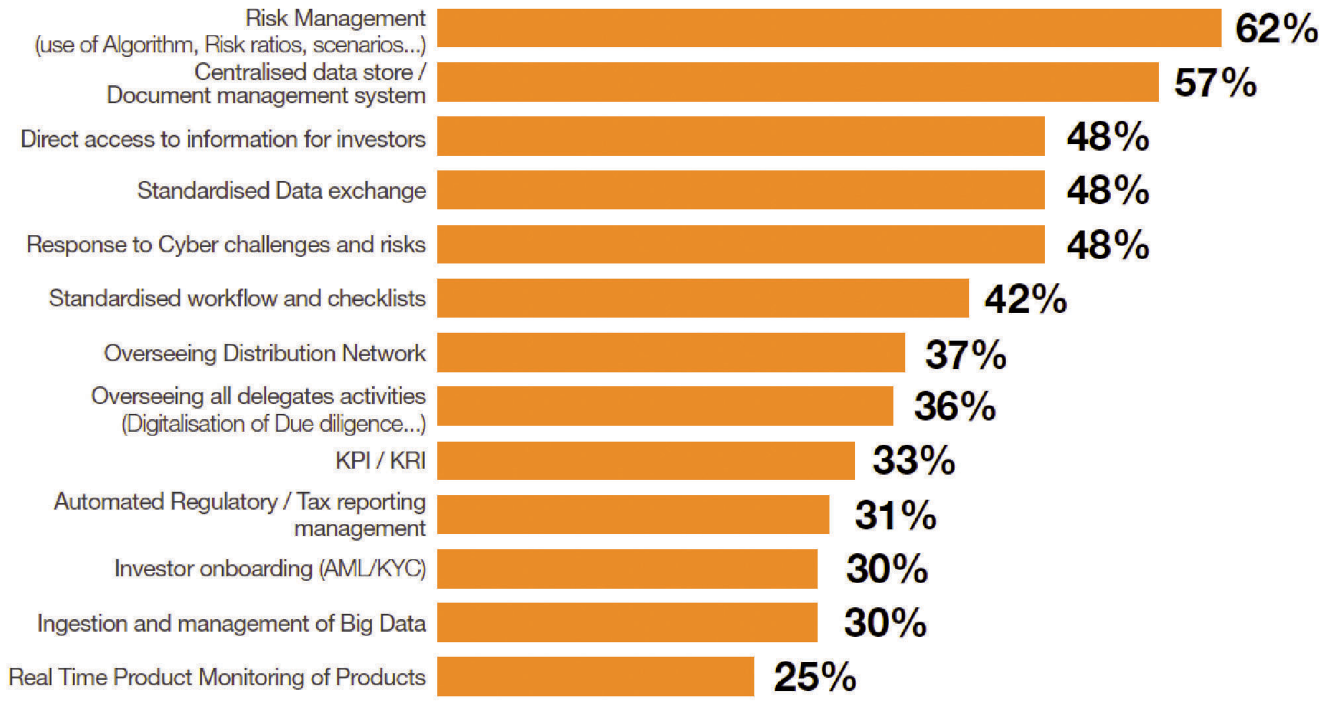
The process-heavy, regulation- and security-driven interaction between manager, asset and depositary looks like a prime target for automation. However, the reality is more complicated. Technology solutions are relatively widespread in risk management, but rather less so for other functions and processes across the fund industry in Luxembourg and elsewhere.

10 YEARS OF INNOVATION

Fund services: Not so digital

Digitalisation of management companies is patchy, particularly for core depositary and administration functions. These digitalisation adoption stats for ManCos can reflect the trend in the depositary space since ManCos can delegate their functions to depositaries.

Use of digitalisation and technology solutions in ManCos today



Source: PwC Observatory for Management Companies, 2022 Barometer

Heavier regulatory burden

Investor protection sits at the core of EU and Luxembourg fund law. The Alternative Investment Fund Managers Directive (AIFMD) became law in Luxembourg in July 2013, setting out what kind of entities can be a depositary, their responsibilities and potential liabilities, and how conflicts of interest should be managed.

Monitoring, oversight and reporting rules are becoming increasingly prescriptive, and the data burden is only set to grow. The EU is currently reviewing and revising the AIFMD, as well as the Markets in Financial Instruments Directive (MiFID) and its associated regulation, MiFIR, which deal with market transparency, as well as introducing measures to strengthen disclosure regarding sustainability and ESG claims.

Depositaries must stay abreast of legislative changes to ensure that their processes, data capture, and reporting (and thus of the investment funds to which they provide services) remain compliant in all the jurisdictions where the funds are marketed and sold.

Financial and reputational risks

Depositary oversight functions cannot be delegated, although safe-keeping of assets can be, providing certain conditions are met. Depositaries are normally credit institutions and investment firms that comply with capital adequacy requirements and are authorised within the EU, or owned by a non-EU institution that is deemed to be under equivalent supervision. However, for certain alternative investment funds, a "professional depositary of assets other than financial instruments" (PDAOFI) can be appointed, sometimes referred to as "depositary light". These depositaries cannot hold cash, which always needs to be entrusted to a financial institution.

*The CSSF and other authorities are increasingly cracking down on firms that breach the rules, both asset managers and service providers. In recent months the CSSF has issued **six-figure penalties** against multiple fund industry participants for administrative failings such as failing to return a questionnaire; fines for more serious breaches of reporting and compliance requirements can exceed €1m.*

The implications of such fines are **more than just financial** – no longer can they be considered merely a "cost of doing business", now that penalties are made public. Investors want evidence that effective and compliant processes are in place and that the fund managers with which they invest use reputable depositaries and other service providers. Those that do not offer a more digital experience or demonstrate regulatory rigour **will lose out**.

A growing talent gap

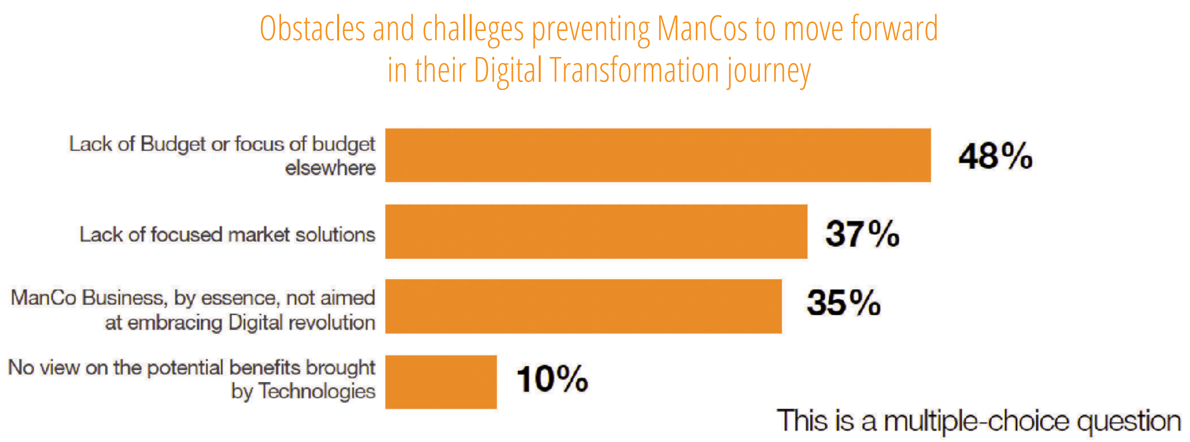
Fund firms have long been concerned about the difficulty of securing the skills they need in Luxembourg. Salaries are rising rapidly in response to competition between employers, exacerbated by the increased cost of living. **Staff retention** can be a struggle when senior management and medium-level staff are liable to be headhunted almost on a daily basis.

3. The Digitalisation Dilemma: Budgets, Priorities and People

The arguments for cost and operational efficiency grow **stronger by the day** as a challenging macroeconomic environment and market volatility have become the new norm, but practice often lags behind. Much of the interaction between fund managers, depositaries and other service providers across the industry employs outdated, often analogue technology. Why are most participants still reliant on (static, fragmented) Excel spreadsheets and e-mail exchanges to manage their data governance, let alone fax machines as a communication tool?

According to PwC's survey, budgets get the biggest blame; senior management focus is elsewhere and 'back-office' functions are seen as a cost centre, rather than a potential source of savings and efficiency. There's also a tendency to ignore other areas of added value such as continuity and transparency, both of whose positive input is hard to quantify, but which are potentially catastrophic and extremely costly if they go wrong.

Barriers to digitalisation remain



Source: PwC Observatory for Management Companies, 2022 Barometer

Yet while budgets are shown to be one of the biggest barriers to digitalisation, budgetary resources can be saved by investing in digital technology. Processes can be sped up (automated), meaning higher productivity and lower cost.

Without a prevalent **digital-first culture** within an organisation, implementing any change is always a risk, but it is always likely to appear a bigger challenge to those who are not digital-savvy. No depositary staff want their roles to be reduced or eliminated by digitalisation.

> *The key is in articulating the ultimate goal: digital technology can help a compliance manager's day job and free them from high-volume manual tasks – data checks via spreadsheets – for more value-added functions such as data analytics and building relations with clients and investors*

Offering a more digitalised – or transformational – culture, meanwhile, can help attract the next generation of employees seeking a modern, digital-focused working environment. Becoming a digital leader in the market can also help businesses retain experienced staff as their job experience will be improved.

Another key factor contributing to successful digital implementation is aligning IT and business teams. A shared end vision can help bring both functions together. According to PwC's 2002 Digital IQ Leaders report, companies that excel in aligning strategy with technology (defined as "Digital IQ Leaders"), outperformed their peers in terms of revenue growth over the previous three years (as well as during the first 12 months of the Covid-19 pandemic). The PwC researchers also conclude that Digital IQ Leaders are more likely to create better customer experiences, improve business continuity, and improve decision-making through better data analysis.

Further reasons and solutions for why financial institutions don't innovate are outlined in Governance.com's mini white paper, "Five Reasons why financial institutions don't innovate"

DEPOSITARY DIGITALISATION IN THE REAL WORLD

Case Study

Two critical components of a depositary's responsibilities to its clients are the production of an asset register and the performing of initial and periodic asset verification.

Once automated, the workflow and processes required to produce an asset register and perform verification checks can be shortened from around a day of manual operations to a few minutes while eliminating the risk of human-induced error.

> *"Our decision to digitalise our asset verification and asset register has been a game-changer. We are set to save significant time and money while ensuring our regulatory rigour is greater than ever and improving our client and investor experience. My team is already impressed by the efficiency and ease of our new digitalised system.* ***I highly recommend a digital solution to any depositary looking to streamline its processes and improve its operations,"*** *says Lucien Lorang, Head of Business Implementation at BNP Paribas Securities Services Luxembourg.*

An asset register is a comprehensive list of all the assets that a depositary holds on behalf of its clients. The asset register typically includes details such as the type and value of its asset, the name of the issuer, and the date of its acquisition.

The asset verification task of a depositary involves ensuring that the assets listed in the asset register are physically present, accounted for and securely stored.

Currently, both the asset register and asset verification are typically performed via a largely manual approach, involving e-mail exchanges between compliance teams and data storage and checks via static spreadsheets.

This manual approach is highly time-intensive and stressful to perform, as it leaves the workflow and checks in the hands (and minds) of individuals.

Technology can automate the workflow and processes required to carry out the checks, and the production of the asset register, replacing the pain and workflow complexity. Compliance managers gain time and freedom for more value-added tasks such as high-quality analysis and stakeholder relationship-building.

Cast savings calculator

Taking the asset register production as an example, the typical time needed to produce the register manually is several hours. A digital solution (through process automation) can produce the register within 30 minutes. If we simulate that as cost savings based on a fund with the following characteristics, the depositary can achieve cost savings equating to the equivalent of up to several full-time employees - this frees those employees up for higher-value tasks and productivity.

Digital solution explainer:

# of funds	400	funds
# of transactions	2000	10 per year
# of assets	8000	20 per fund
Cost of Labour p.a. EUR	100.000	
Days in the year	220	
Cost per day in EUR	455	
# of emloyees	15	
GOVERNANCE.COM system cost per employee (including implementation) EUR	500	

Simulated cost savings – calculation extract:

Asset register production Manual approach	Production Time: 8 Hours	Annual Cost: >180,000 EUR	Asset register production annual cost savings through automation >160,000 EUR
Asset register production Automated Approach	Production Time: 0.5 Hours	Annual Cost: >11,500 EUR	

*Includes cost of GOVERNANCE.COM system implementation and licenses

Digitalisation is an easy way to scale up a depositary's operations. For example, once one process is automated, automation can be tailored to the next process. In this way, a depository can scale up its operations through digitalisation while accumulating cost and efficiency savings and remaining regulatory rigorous.

The total scaled-up cost savings to be gained by automating all audit confirmation and transaction processes for the above fund scenario would be over 1.3 M EUR.

Annual cost savings through automation of all audit confirmation and transactions.

>1.3M EUR

Want to discover and pilot our cost savings calculator?

Contact us at Request a Demo. We can work with you to calculate your time and cost savings potential to be gained through automation.

4. A People-Friendly Approach to Digitalisation of Depositary Solutions

It is crucial that thought goes into communicating the benefits of digitalisation – how it works in practice – and addressing any related fears among staff and executives at all levels about getting on board with any automation-driven overhaul of processes.

The choice of provider and IT infrastructure, education in how to use and integrate their systems, and simple low-code solutions are central to making digitalisation a success.

Overcoming status quo inertia

All stakeholders must be convinced of the benefits of automation. Low-code solutions are people-friendly, making it easier to train staff and to implement and use digitalised asset registry and verification, oversight controls, transaction monitoring and the many other processes that depositaries conduct.

A low-code approach can help overcome understandable human caution that leads to a preference for the status quo over new processes and technology. It enables staff who are not IT experts to manage their own solutions to specific issues they face, without having to manipulate computer code.

Turn mistakes into learning opportunities

Nobody wants to make mistakes at work that might impact their personal ambition, earnings and reputation. That is particularly so in financial services, given the real risks of supervisory penalties.

A low-code approach flips the fear of mistakes into a learning opportunity. Small-scale errors can be easily identified, learned from and rectified. It allows new ideas to be tried out, sandboxed and segregated from existing operational functions, until they are proven to work.

Competitive advantage

Compliance is often seen as an unwanted burden, a roadblock to productivity, and a drain on resources. But digitalisation can be used to improve a depositary's overall competitiveness - boosting efficiency if fewer mistakes are made and need rectification, reducing expense, and providing timely data.

Faster onboarding, along with know-your-client and anti-money laundering processes, enable asset manager clients to put investors' money to work more quickly. Reducing the time needed for production of asset registers to minutes, updatable at any time, is a major benefit to fund management teams, particularly when markets are volatile. And institutional and retail investors are increasingly demanding digital solutions to deliver the transparency they want. In many cases clients are used to the smooth experience offered by global tech applications and want the same seamless process for their fund investment.

Complexity and agility

Digital transformation projects can be highly complex, too big and unwieldy to be managed effectively or implemented rapidly. An agile philosophy and approach can help break down digital change to easily managed tasks that demonstrate their benefits quickly and efficiently.

A depositary needs to be agile and flexible, too. If resources and staff find it hard to manage a comprehensive all-in-one revamp, an incremental approach may be easier on budgets, not to mention staff stress levels and well-being at work. This approach can be self-reinforcing; a small success can encourage further steps toward digitalisation, innovation and an embracing of new technologies.

Breaching the language barrier

Asset management is an international business; investors are everywhere, and staff (especially in Luxembourg, the global hub for cross-border funds) tend to be multilingual. Although English is the industry's lingua franca, native and non-native speakers may easily misunderstand each other's needs or the technical specifications of unfamiliar IT solutions. A low-code philosophy addresses these issues too, through visuals and drag-and-drop interfaces that enable non-experts to create and modify functions and workflows.

5. What's Your Next Step?

Now is the time to take your next step toward digitalisation.

> *Demands on fund depositaries and their teams have never been greater, and are only likely to increase in the future. Investors' demand for more granular data and digital, seamless integration is becoming a key differentiator in their choice of funds, so it's an increasing priority when asset managers, management companies or general partners are choosing service providers. The regulatory trend is toward more digitalised data and reporting, increased oversight, greater transparency, and the risk of penalties if things go wrong.*

Meanwhile, the inevitable further rise in the regulatory burden for the asset management industry, along with the growing reputational (and financial) jeopardy that compliance penalties can entail, are set to increase pressure to adopt digital solutions to manage an even broader range of data in the future.

Resistance to change is understandable, particularly in a fund industry hardly known for its pioneering pursuit of digital solutions. Breaking down requirements and processes into manageable, incremental solutions can result in faster, more efficient and lower-cost implementation and higher levels of acceptance by those who use them.

The good news is that a mature ecosystem of solutions exists to help the industry take the leap into the digital world. To find out more about our depositary solutions, low-code philosophy, and solutions, contact

info@governance.com