

FRAMEWORK FOR THE DUE-DILIGENCE PROCESS ON SUB-CUSTODIANS

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Introduction

When assessing the liability of a financial institution in its safekeeping role, the level of due diligence that it performs on its sub-custodians is a determining factor. This link is even more obvious when reading the responses received by the European Commission in its September 2009 consultation regarding the UCITS depositary function.

In addition, in the Financial Times of 11 October 2009, Eddy Wymeersch, Chairman of CESR was quoted as having said that "Depositaries cannot be expected to take full ownership and offer full guarantees, only that they carry out proper due diligence. They must, however, be expected to investigate things fully."

So how should a depositary bank carry out its due diligence process in a manner, which clearly demonstrates that it has properly performed its duties in this respect? And how should the risk governance bodies perform their oversight over this due diligence process?

Applying a common framework will certainly help in finding the right answers to the above questions. The terminology used in this article is consistent with the CESR response to the European Commission consultation on the depositary function. In accordance with the UCITS directive, UCITS assets must be entrusted to a "depositary" for safekeeping. It is clear that delegating the custody of part of the UCITS assets to a sub-custodian is an important or often obligatory tool available to depositaries. The terms "depositary" and "sub-custodian" in this article are to be understood in this context.

Framework for Due Diligence of Sub-Custodians

The framework in the diagram below presents an overall view of the areas that are important when carrying out a due-diligence process.



Each of the framework components above also deals with the management of risk, whether it is custody risk, operational risk, counterparty risk or fraud risk.

When applying the framework, it is important to bear in mind that:

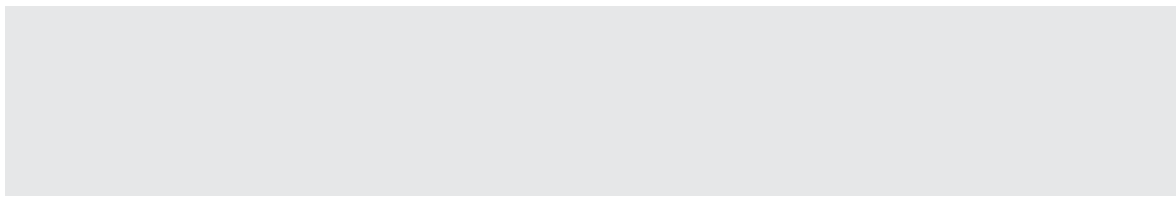
- There is no one-size-fits-all method, so detailed questions to be asked at each step of the framework need to be relevant or tailored to the circumstances,
- The devil is in the detail, which means that for sub-custodians in higher risk or more exotic jurisdictions a higher level of scrutiny is needed,

- From an oversight perspective, applying the right mindset is crucial when analysing and concluding on any red flags identified during the due-diligence process. Recent fraud cases have highlighted the importance of getting this step right,

- Due diligence is an ongoing process and this means that there needs to be continuous monitoring even after the selection decision (and at least annually), as circumstances also continuously change, new risk indicators come to light and benchmarks evolve,
- Sufficient documentation of the due-diligence process will help the depositary, in case of litigation, to prove that it has properly performed its duties; on the other hand, poor documentation will undoubtedly increase litigation risk for the depositary.

So what are the general items to be considered for each step of the framework?

A summary is given in the following table :



Framework Component	High-level Questions when Performing Due Diligence
<p>Safeguarding assets</p>	<ul style="list-style-type: none"> • Is the sub-custodian supervised by a regulatory authority in its jurisdiction? • Is there sufficient segregation of assets at the sub-custodian? • Are there legal and contractual clauses that provide for direct and immediate access to the assets if the sub-custodian goes into financial difficulty? • Are contracts in line with local regulations and local law and do they reflect accurately the reality on the ground? • What are the legal and regulatory constraints in the jurisdiction of the sub-custodian that undermine the depositary's role, responsibilities and duties as agreed between the depositary and its client? For example, the law and regulations in the sub-custody country may not recognize at all the depositary at the top of the custody chain, whereas the client will still expect the depositary to be able to fulfil its role as contractually agreed between the depositary and the client. • Will the assets be re-used or re-hypothecated? • Is there a mechanism for confirmation of the existence of assets by an independent party? • Is the sub-custodian subject to potential conflicts of interest? • Is there adequate segregation of functions down the sub-custody chain? • Does the sub-custodian have appropriate insurance coverage against loss of assets?
<p>Operations</p>	<ul style="list-style-type: none"> • Does the sub-custodian have an adequate infrastructure, resources and systems to process transactions efficiently and effectively? • Does the team in place have the relevant experience and expertise? • Are the operational and governance processes in place compatible with and effective in ensuring that the contractual basis of the appointment is valid (i.e., not undermined in the sense that contracts agree one thing, but then it is not reflected in the reality of the sub-custodian's operations)? • Is there a sound internal control framework that indicates operational risk is properly managed? Is it tested via a SAS 70 or ISAE 3402 audit report? • Is the level of automation/straight-through processing acceptable? • Are there areas where significant manual processing is required at the sub-custodian, and what are the implications on our own flows and on stakeholders? Is there an associated fraud risk?

Framework Component	High-level Questions when Performing Due Diligence
Operations (Cont.)	<ul style="list-style-type: none"> • Is there a solid risk management framework? • Have service levels and responsiveness been defined in line with expectations and best execution principles? • What is the mechanism for issue detection and the escalation process to depositary?
Business Resilience	<ul style="list-style-type: none"> • Does the sub-custodian have a business continuity plan that is tested regularly? What did the previous test highlight as issues? • Do the sub-custodian's systems have sufficient processing capacity to process large volumes of transactions? • Have there been indicators showing that business resilience is weaker than initially assessed?
Financial Strength	<ul style="list-style-type: none"> • Is the sub-custodian financially sound and is there a stable process in place to identify any contra-indicators? • What types of capital and liquidity buffers are available to the sub-custodian to deal with stress scenarios? • Is the sub-custodian sufficiently creditworthy considering the expected counterparty risk exposure that may arise during the normal course of business?
Transparency / Governance	<ul style="list-style-type: none"> • Is there an appropriate risk culture at the sub-custodian? • Is there evidence of a sound risk management function? • Is there transparency over processes, controls, governance bodies, beneficial owners, and the company's main sources of income? • Is there transparency over weaknesses detected at the sub-custodian and corrective action taken?

Red flags detected in the due-diligence process need to receive proper attention from the right level of management. This step is not to be underestimated, as it usually makes the difference between good risk management and no risk management.

Conclusion

The above framework and related high level questions can help each depositary to evaluate, whether its past due-diligence process has been carried out with a sufficient level of rigor and detail to cover risks with low probability of occurrence but with high impact (e.g. custody risk, fraud risk). It also helps governance bodies to assess whether they have overseen the whole process and paid particular attention as to how any due diligence red flags have been addressed and how they have been reflected in the sub-custodian's overall evaluation.