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European Depositaries: One Vision, Many Markets

Overcoming Fragmentation to Create a Cohesive Ecosystem

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Contents

Introduction

Throughout the European Union (EU), fund depositaries and service providers operate under a single regulatory framework: the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive for plain vanilla funds and the Alternative Investment Fund Managers Directive (AIFMD) for alternative investments.

However, despite this unified framework, significant operational differences persist among EU countries, hindering the development of a fully harmonized and cross-jurisdictional operating model.

Operational misalignments exist across the fund depositary value chain activities, creating duplications of efforts and teams, differences in processes and systems, and limited synergies regarding data infrastructure, technology, and hosting. **This, in turn, involves three important drawbacks:**

01 A limited ability to leverage scale at the EU level to improve efficiency and process optimization;

02 An uneven user experience for asset managers and management companies (ManCos), whose products are established in multiple jurisdictions; and

03 Regulatory uncertainty and potential arbitrage between domiciles due to an uneven playing field across the EU.

This whitepaper aims to identify operational misalignments across EU countries and their root causes. By analyzing these disparities, we propose methods for strengthening EU-wide harmonization in fund depositaries. Our guidance acknowledges the limitations faced by industry players, recognizing that while some root causes can be addressed, others necessitate more comprehensive alignment in supervisory practices.

Ultimately, this effort seeks to benefit industry practitioners, asset managers, and national and European authorities by fostering a more cohesive and efficient operational environment while operating under a stronger level of regulatory certainty.

> By analyzing these disparities, we propose methods for strengthening EU-wide harmonization in fund depositaries

1. Charting the fragmentation of the EU Depositaries landscape

Analyzing fund depositaries operational frameworks across the EU reveals significant differences throughout the value chain. Operational procedures can significantly vary between countries, even within the same organization and for similar investment strategies. This disparity can hinder the emergence of an integrated model at the EU level, create competitive disparities, and complicating regulatory supervision. The increased operational costs for depositaries are inevitably passed on to asset managers and, ultimately, to end investors.

To understand the extent and nature of these differences, we benchmarked several countries' relative resourcing needs for a comparable process and investment strategy.

By isolating our analysis per investment strategy and examining key operational processes that constitute the five building blocks of depositaries activity, we observed significant differences in resourcing needs across countries. This indicates that certain factors promote more resource-efficient processes in some countries compared to others.

This paper aims to isolate and understand these factors and identify ways to overcome harmonization barriers.

> Operational procedures can vary significantly between countries, even within the same organization and for similar investment strategies, as well as client or fund type

Overview of key depositary functions / activities

Oversight

- Review transactions' timely settlement;
- Review subscription and redemption activities;
- Oversee the net asset value (NAV); and
- Oversee the income distribution.

Cashflow Monitoring

- Review the daily cash flows;
- Review significant cash flows to ensure consistency with the constitutional documents;
- Review the cash reconciliation performed by the fund accounting (FA) function;
- Follow up on discrepancies.

Safekeeping

- Check the assets' ownership and existence at the time of purchase and sale;
- Check the assets' ownership and existence at least once a year (end-of-year assets confirmation);
- Maintain an up-to-date book of record keeping for the investment funds;
- Ensure safekeeping of all assets held in custody.

Due Diligence

- Conduct thorough checks on delegates and service providers, procedures and controls, including fund managers, fund accountants, transfer agents (TAs) and custodians, to ensure they meet regulatory requirements.

Investment Restrictions

- Ensure the investments being made are in line with the constitutional documents; and
- Oversee the investment restrictions.

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Figure 1 illustrates the average distribution of employees (full-time equivalents, or FTEs) across operational functions in various EU jurisdictions.

The contrast between liquid and illiquid strategies is significant, particularly regarding safekeeping and cash flow monitoring. Illiquid strategies tend to be much more FTE intensive, largely due to safekeeping's manual activities compared to liquid strategies' higher level of automation.

Similarly, cash flow monitoring for illiquid investments involves more manual processes, compared to the higher degree of automation in liquid investments.

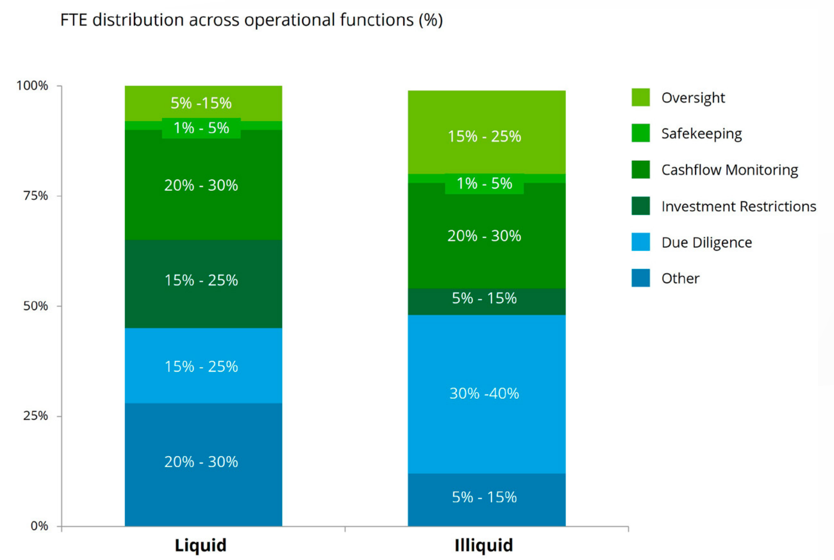


Figure 1

Even more striking are the workforce discrepancies across EU countries.

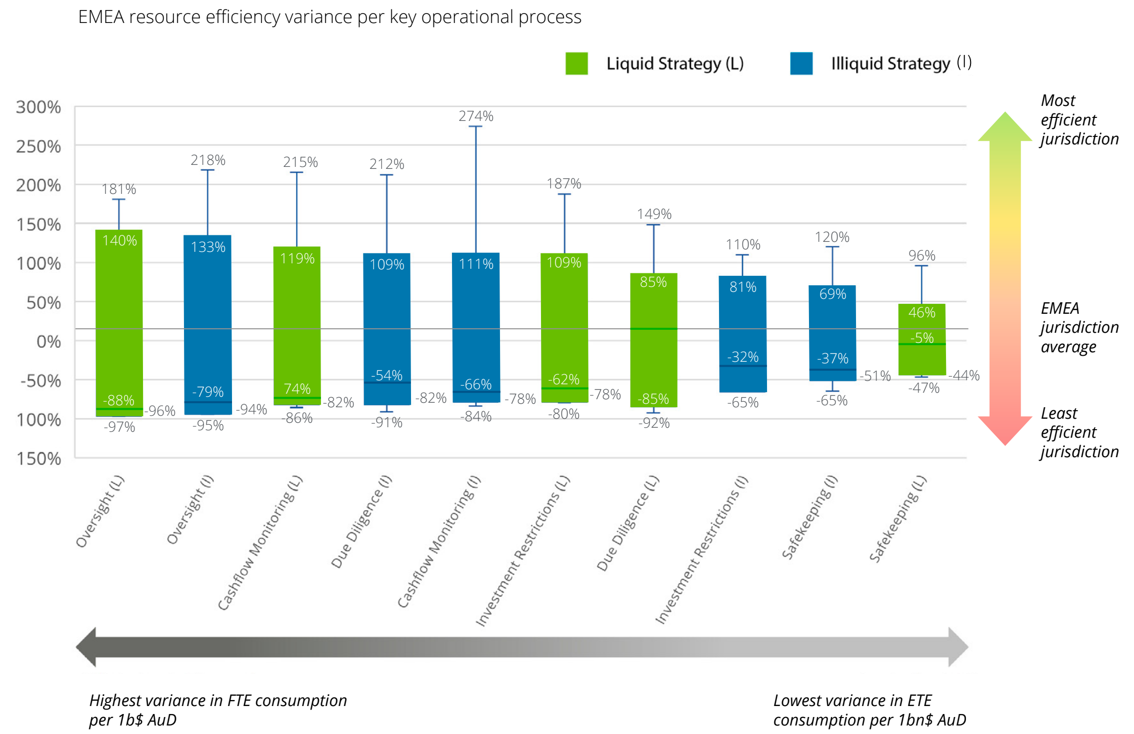


Figure 2 shows the vast differences compared to the EMEA average and between jurisdictions in workforce efficiency, further emphasizing the uneven playing field at the EU level.

Figure 2

Therefore, understanding the factors contributing to these disparities is essential to achieve a more unified EU operational framework, which we explore in the next section.

2. Uncovering the drivers and root causes of national differences

We identified three main root causes of the significant operational differences between European countries.

- Regulatory & supervisory variations:

  The integration process of European laws into domestic law can vary widely between countries. This process, grounded in the principle of subsidiarity, acknowledges that directives need to be incorporated into each EU member state's pre-existing regulatory frameworks and market practices. These necessary adaptations have led to legislative nuances, sometimes resulting in significant operational disparities. Additionally, subsequent regulatory bulletins and guidelines can further lead to changes that contribute to these differences in operational approaches after the initial implementation.

- Country market practices & approaches:

  Depositary activities are integral to the broader asset servicing landscape, where asset managers' sourcing strategies vary across countries and among providers within those countries. While outsourcing these functions to a single provider is favored in certain regions, a best-of-breed approach prevails in others, with asset managers either retaining certain functions internally or outsourcing to multiple providers, reflecting both market practice across providers within a country national and provider-specific practices.

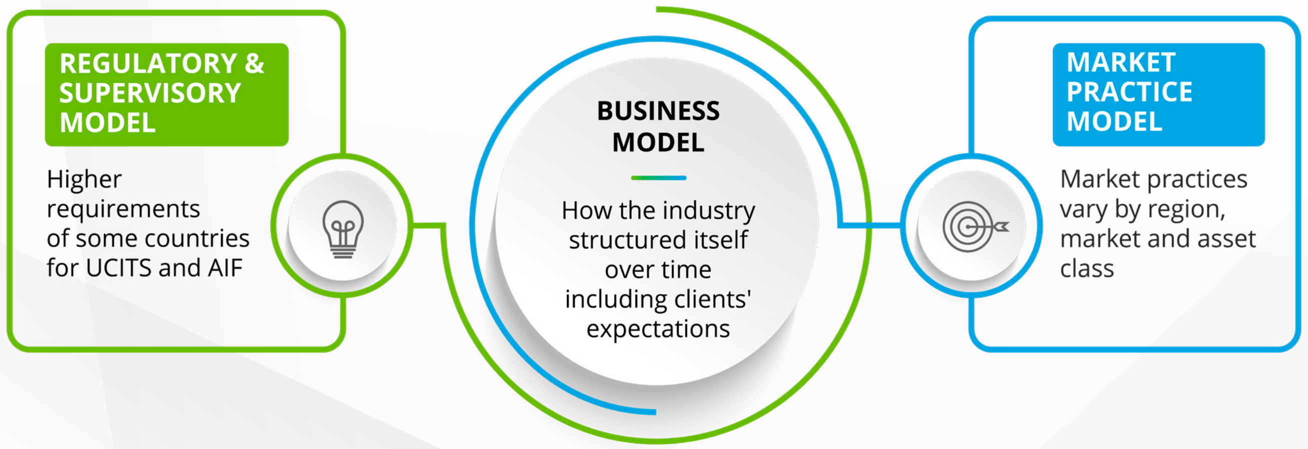
  This variation influences how depositaries operates, as the level of integration with other asset servicing functions shapes the execution of these operations. Unlike the previous root cause that stems from regulatory and supervisory practices, this one allows individual players to develop tailored responses to overcome potential differences.

- Business & Servicing Models

  To respond to the previously mentioned regulatory and market practice drivers, individual oversight models have emerged, shaped by factors unique to each organization. These include an organization's individual servicing approach, local interpretation of prior feedback from regulator reviews, specific client requirements (including those of captive asset managers, where applicable), and local acquisition history, which may have introduced significant legacy systems, operations, and teams.

  Today, this area offers market players the greatest potential for efficiency gains.

> Three root causes explain the operational misalignments between European countries



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2.1 Regulatory and supervisory variations

In this section, we analyze two themes to illustrate how national regulatory nuances have emerged and led to operational differences. These differences have, in turn, created situations that are now challenging to reconcile at the EU level from an operational perspective.

> National regulatory nuances have led to operational differences

Different national depositary rules

Some of the variations in depositaries' roles and liabilities across EU countries derive from the specific responsibilities placed on them by different countries. For example, some nations focus on verifying the accuracy of NAV calculations, while others require depositaries to ensure the NAV's correctness, influenced by pre-existing regulatory frameworks shaped by incidents like Bernie Madoff's Ponzi scheme.

This nuance has translated into significant operational differences at two levels:

- Timing of controls

  In jurisdictions that place a greater emphasis on depositary responsibility, controls are typically performed "ex-ante". This means that key activities, such as NAV calculations and cash monitoring, are verified and validated before the finalization and release of the NAV and /or the release of an expense, to prevent errors and the need for post- adjustment.

  For example, Germany mandates a stringent ex-ante approach with multiple validation layers to ensure complete accuracy. However, the same depositary would adopt "ex-post" reviews in other countries, where supervision is focused on monitoring the accuracy of these activities.

  These nuances in national regulations lead to depositaries adopting significantly different controls, greatly affecting how their functions are organized and resourced across various jurisdictions.

  While these differences pose challenges in the absence of structural supervisory alignment, individual business models can be adapted to mitigate these impacts. As we will explore later in this paper, these models can effectively navigate and overcome national regulatory discrepancies, reducing the friction of these variations.

> Timing and depth of controls may depend on local regulation

- Depth of controls

  Other variations in supervisory approaches, whether specified in national law or through informal guidelines, can also lead to operational misalignments—for example, different thresholds for cash flow monitoring and NAV tolerance checks. As discussed later in this paper, this category of misalignments is the most challenging obstacle to overcome. While it cannot be fully aligned, the fragmentation resulting from these regulatory nuances can be mitigated within a harmonized pan-EU operating model, mainly through significant investment in redesigned processes and appropriate technology.

Different substance and outsourcing oversight expectations

The ability to transfer activities to a center of excellence (CoE) within the group can vary between countries, even though these supervisory practices are not explicitly formalized.

Supervisory expectations around local substance requirements often drive these differences. While some countries are more flexible in accepting intra-group outsourcing, others impose stricter requirements that demand a more prominent local presence.

In this context, market players can leverage two approaches to foster a stronger operational alignment across EU jurisdictions:

> Supervisory expectations around local substance requirements often drive these differences.

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- **Reinforce outsourcing oversight:**
  Bolstering this oversight ensures robust governance and accountability. This can be undertaken through two critical steps:
  - **Strengthen the justification for outsourcing:** transparent and compelling arguments for intra-group outsourcing must be provided. The rationale should go beyond reducing the number of employees and focus on creating a pool of expertise to leverage the best national practices. This pool should apply these practices consistently across the organization, enhancing overall regulatory effectiveness.
  - **Design a clear oversight model:**
    a well-defined oversight model is crucial for effective governance. It should emphasize local review and decision-making layers as key components. By reinforcing local oversight, organizations can ensure that outsourced activities align with national regulations and supervisory expectations, thereby maintaining local operational integrity and compliance.

> Different local interpretations of EU regulations can affect the ability to transfer activities to a center of excellence

- **Sharpen the definition of preparatory tasks:**
  Refining these definitions helps ensure consistency and precision when delegating and executing activities. Two steps can help achieve this objective:
  - **Map the outsourcing process' preparatory tasks:**
    this includes identifying each task and its purpose, dependencies, and required skill sets. Supporting documents should clarify how responsibilities are allocated across the value chain.
  - **Standardize the preparatory tasks' procedures:**
    this should include comprehensive guidelines that detail the specific requirements, steps, and quality checks necessary for each task. By establishing uniform procedures, organizations will reduce variability, ensuring that preparatory tasks are performed consistently across different jurisdictions.

2.2 Country market practices and approaches

Market practices vary by region, market and asset class. Established through market participants' collective experience and consensus, they generally aim to promote transparency, consistency and fairness in financial activities.

These market practices are key to understanding operational misalignments across EU countries, and can be broken down into several key components:

Servicing model: stand-alone versus all-in service

Market practices vary greatly in how depositary services are integrated with other asset servicing components, such as custody, FA, TA, and ManCo services. The level of integration can significantly shape the depositary oversight model in place.

Depositaries operate as stand-alone entities in some countries, providing only core depositary services. Our Germany case study (see market practice deep dive box) illustrates how this servicing model has influenced local depositaries' oversight i.e., while in Germany, compared to other jurisdictions, depositary and custody functions are typically housed within the same entity, and while FA can be outsourced, it has historically been less common for ManCo to outsource FA compared to other jurisdictions.

In contrast, depositary services in Luxembourg and Ireland tend to be integrated with other asset servicing components. However, in Ireland, legal entity separation is required, meaning that depositary and custody must be in a different legal entity from fund accounting, even if they belong to the same group. This distinction reflects the structural differences in how asset servicing functions are outsourced or separated across markets.

> Beyond regulatory considerations, European markets are shaped by market practices that evolved in line with local customs, working principles and widely accepted procedures

Risk perception and consideration

The perceived liability and risk of asset loss, oversight failure, or compliance breach—which could lead to regulatory sanctions or financial penalties—significantly influence market actors' responses on a country-by-country basis.

This dynamic has driven the development of country-specific approaches that are often endorsed by national industry associations, resulting in unique operational practices across jurisdictions. These differences affect control types, frequencies, depth, and timing.

Local client requirements and expectations

Market practices are shaped by local clients' unique requirements and expectations, especially concerning specific service components. For example, there is often a heightened emphasis on carefully managing due diligence processes for portfolio managers and a strong demand for accurate and prompt NAV controls.

These local preferences have driven the customization of operational models at the country level, ensuring each client base's distinct

needs and standards are fully addressed.

Reassessing service levels to more closely align with other countries' standardized approaches could enhance operational consistency across regions. While this shift may present commercial challenges, it could also be a strategic leverage point during fee negotiations.

> The German depositary model highlights the need to consider local market dynamics alongside regulatory differences when aligning EU operational procedures

Market Practice Deep Dive: German NAV Oversight

German law introduces two distinct models for NAV oversight: Model 1 and Model 2. Under Model 1, the depositary must have unrestricted access to the technical systems of the fund management company without relinquishing its control responsibilities. Under Model 2: the depositary relies on its own (shadow) fund accounting system to fully recalculate the NAV, ensuring its accuracy before confirming it for publication.

The Model 2 approach provides the necessary assurance for the depositary to authorize the NAV release. Thus, it is most commonly used by the largest depositaries. However, it requires significant resources compared to the NAV oversight process typically applied in other countries, which often focuses on periodic review of the NAV process and key pricing moves.

This resource intensity stems partly from the historical separation between depositaries and fund accounting activities, typically managed by local ManCos (Kapitalverwaltungsgesellschaften, or KVG). In this setup, depositaries lack the necessary comfort level to authorize NAV release. Conversely, if the Group providing the German depositary also handles fund accounting functions, it may be more inclined to use Model 1, which more closely aligns with other European jurisdictions' practices.

Understanding these differences is crucial for harmonizing operations across the EU fund depositaries sector. What often appears as a regulatory misalignment is, in fact, due to local market dynamics shaping the business model.

2.3 Business and servicing models

In response to these local and market dynamics, financial participants have implemented a range of strategies.

This section examines six approaches typically applied at the national level, frequently disregarding the operational frameworks of other countries. As a result, this exacerbates misalignments and misses valuable opportunities for cross-border collaboration.

> Market players can strategically address six key factors to unlock the efficiency gains of a harmonized EU operating model

Risk-based approaches

Risk-based approaches form the bedrock of a depositary oversight model, serving as the primary lens through which the entire system is designed and operated.

The perception of risk materiality plays a crucial role in shaping this model, determining which areas require the most stringent oversight and controls. By focusing on the most significant risks, the oversight model is tailored to address each market's unique challenges and vulnerabilities.

However, when this risk assessment is performed on a national level, it often leads to vastly different approaches across locations. Each jurisdiction may have its own understanding of what constitutes material risk, which is influenced by local regulations, market conditions and client expectations. These differences in perception of risk can occur at the regulator or at the depositary level.

As a result, despite all these national oversight models being risk-based, they can vary significantly from one country to another, leading to a lack of consistency and missed opportunities for cross-border harmonization.

Organization of intra-group CoEs

Using and effectively structuring CoEs in a consistent way plays a crucial role in achieving harmonization and scalability.

However, these centers are not always leveraged consistently across locations—while some regions rely on them heavily, others do so far less.

Additionally, the potential of CoEs is diminished when they are not organized in a functional way. Approaches focusing on specific activities that could be functionalized can enhance consistency and operational efficiency across jurisdictions. However, these approaches require minimum volumes and aligned processes or systems to be successful.

On the other hand, when centers are siloed by country, they often replicate existing inefficiencies and struggle to develop and apply best practices consistently across all locations.

IT and Data integration across asset servicing functions

The overlap of IT systems and infrastructures across countries often undermines the potential to achieve true synergies and efficiencies.

Harmonized IT systems can theoretically facilitate seamless operations, data integration and consistent service delivery. However, in reality, implementing and maintaining these unified systems across multiple jurisdictions can be challenging, complex and costly.

Disparate IT systems not only lead to inefficiencies and higher operational risks, but also significantly drive up costs.

Despite these challenges, investments in unified IT platforms are critical to support global asset managers and investors. In addition to capital investment, the ability to overcome legacy systems and navigate national regulatory requirements is key.

Servicing model

The choice between a full-service and a stand-alone service model has a significant impact on overcoming national regulatory differences.

Compared to Luxembourg and Ireland, where providers of depositaries services typically offer a comprehensive service range, in Germany, depositaries tend to operate as stand-alone entities focusing solely on core depositary and custody functions, while ManCos tend not to outsource the fund accounting. This separation can complicate efforts to align German oversight activities with broader EU standards.

Implementing an integrated business and servicing model in countries like Germany could enhance operational efficiency and more effectively address diverse regulatory requirements.

Activity alignment and process improvements across countries

All these considerations ultimately underscore the need to comprehensively redesign process flows to align with a pan-European framework.

Achieving operational efficiency across EU countries requires standardizing procedures, adopting best practices, and ensuring consistent service quality.

By integrating and harmonizing activities, such as streamlining NAV calculations and cash flow monitoring, organizations can realize significant efficiency gains, reduce risks, and provide a more uniform experience for global asset managers.

Sourcing strategy

Typical examples of sourcing strategies include technology that enables key operational functions, such as Customer Relationship Management (CRM), Contract Lifecycle Management (CLM), or Case Management Systems. Additionally, sourcing may involve the acquisition of bespoke tool, such as cash monitoring systems.

Depositaries sourcing strategy plays a critical role in their operational model. The choice between using external service providers for non-core activities versus maintaining core activities in-house can affect cost efficiency and service quality.

Our findings highlight the potential for significant savings when addressing these initiatives in a coordinated, cross-border fashion. This approach can lead to considerable workforce optimization and potential impact, that could improve European depositaries overall operational effectiveness and cost efficiency.

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Figure 3 illustrates the potential workforce optimization that can be realized by working and developing each of the six approaches in a coordinated way throughout the depositary value chain activities.

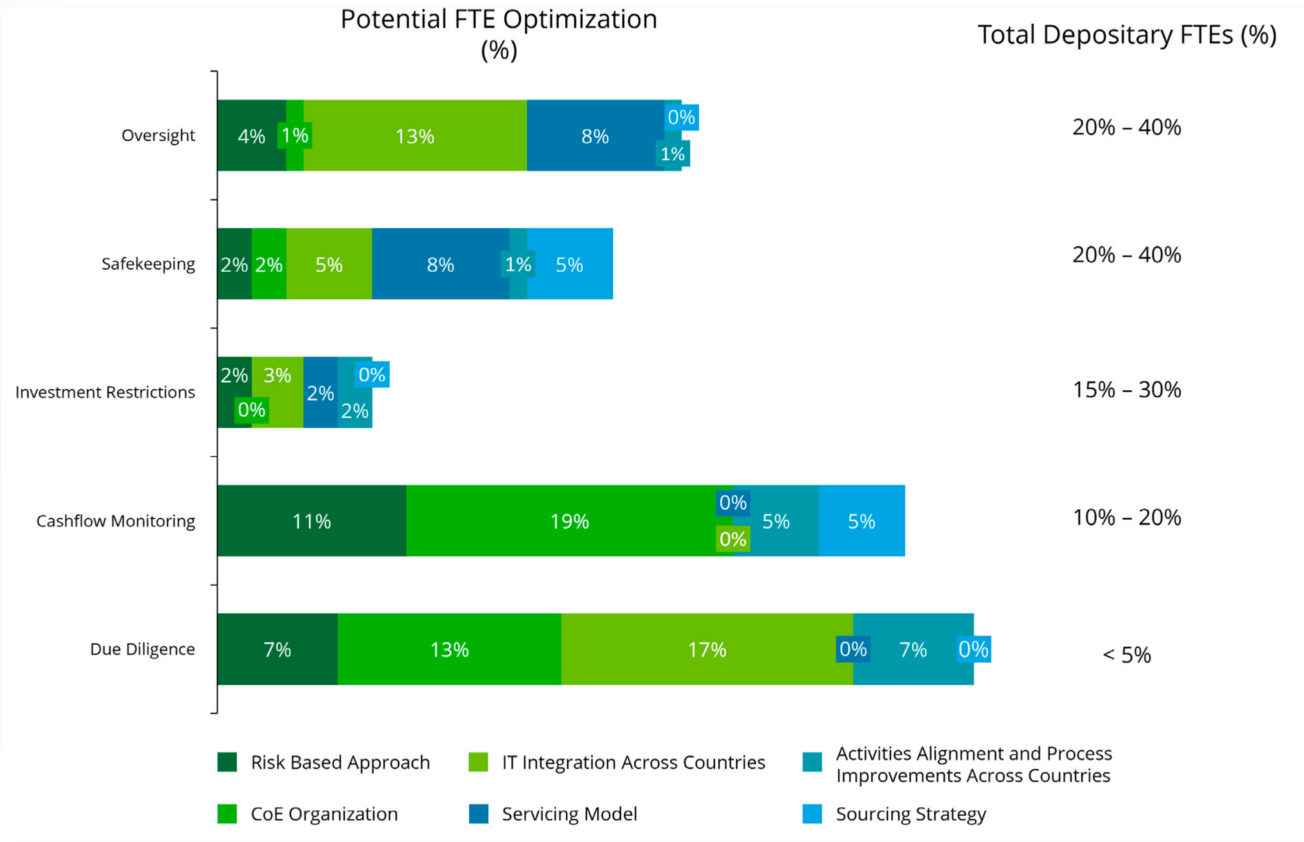

Figure 3

Cost management remains a critical challenge for depositaries, with many struggling to meet savings targets. Deloitte's MarginPLUS survey shows that 56% of respondents achieved less than half their cost-saving goals, highlighting the need for sustainable, enterprise-wide strategies. The graph illustrates ambitious benchmarks, not guarantees, identifying areas for impactful cost reduction. While challenging, these targets highlight where players should focus to optimize operations and improve margins. By fostering a cost-conscious culture and embedding sustainable practices, depositaries can enhance productivity, scalability, and resilience to meet future challenges."

3. Pathways to harmonization: Strategies for addressing operational misalignments

We have categorized the best practices for achieving these harmonization goals according to their feasibility and implementation horizon.

3.1 Readily achievable goals

Create a common EU risk-based approach

- Design an approach that harmonizes control and oversight practices, particularly in safekeeping, cash flow monitoring and oversight activities, to:
  - Standardize the time spent by teams on similar tasks, preventing the over-deployment of resources in one jurisdiction compared to others; and
  - Transfer activities to CoEs and centralize processing on a single system, improving productivity and consistency across the board.

Engage in regulatory harmonization initiatives

- Engage proactively with EU-level regulatory harmonization initiatives to help standardize regulatory interpretations and align compliance practices across different jurisdictions.
- Seek endorsement from national and EU authorities to establish an EU-wide target operating model that ensures consistency while addressing local regulatory requirements. The model must aim to develop a pan-European oversight framework that helps identify and adopt best practices.

Leverage group capabilities

- Establish centralized compliance functions that can interpret and implement regulations uniformly, reducing inconsistencies and operational inefficiencies.
- Leverage delivery and operational centers at the group level as hubs for preparatory tasks, while keeping review,

> As the European depositary market continues to evolve, harmonizing operations across jurisdictions is key for achieving operational efficiency and scalability, while fulfilling regulatory requirements and delivering consistent client service

judgment and decision-making processes in-country. This allows the efficient use of resources while deploying best oversight practices across jurisdictions. More specifically, generic functions, with expertise as main value driver can be optimized by opting for Centre of Excellence solution in order to factor knowledge and reduce overall costs. In parallel, generic functions with efficiency as main value driver could be either harmonized at group level in a shared service center or outsourced to an external service provider.

Align activities and process improvements across countries

- Standardize procedures across EU countries to boost operational efficiency, ensure consistent service quality, and reduce practice discrepancies.
- Implement best practices across jurisdictions, especially regarding NAV oversight and cash flow monitoring.
- Ensure uniform service quality across all jurisdictions to maintain high standards, meet client expectations, and significantly reduce risk and improve operational effectiveness.

Standardize communication protocols

- Use consistent language and terminology across all EU jurisdictions to bridge language and interpretation gaps. This ensures all parties have a common understanding of the performed activities and applicable regulations, which can increase productivity.
- Conduct regular workshops and training sessions involving stakeholders from different countries to foster a shared understanding of regulatory expectations and operational best practices.

3.2 High-impact solutions

Integrate data and IT ecosystems

- Integrate databases and tools in an ecosystem that can facilitate interactions across jurisdictions and process components. This will significantly strengthen the scalability of CoEs, while providing meaningful oversight analytics on single clients and products.
- Develop a common approach to the formation of the depositary book of record across EU jurisdictions, using a single standard and set of booking rules.
- Consider the integration of blockchain technology that could offer real-time oversight by reducing for example the risk of fraud, and providing transparent transaction histories and valuations, while streamlining back-office operations and reducing costs through faster settlement cycles. Additionally, blockchain allows global depositaries to offer new services, such as digital custody and the tokenization of illiquid assets, improving liquidity and expanding investment opportunities for asset managers and investors.

Introduce artificial intelligence (AI) and generative AI (GenAI)

- Transition from fragmented systems to integrated technological solutions coupled with AI capabilities. This allows repetitive tasks to be automated, such as data entry, reconciliation and report generation, reducing manual effort and error rates.
- Implement AI to detect unusual patterns and potential fraud in real-time, enhancing security and protecting assets in line with depositary control obligations.
- Leverage AI for predictive analytics in cash flow monitoring, portfolio valuation, and compliance checks. For example, GenAI can analyze large transaction data volumes to identify discrepancies and predict potential compliance issues before they arise.

Explore external solutions

- Engage with third-party service providers for non-core activities to leverage specialized expertise and technology. This allows depositaries to focus on core activities while delivering high-quality service.
- Form partnerships with fintech firms and other financial institutions to adopt innovative solutions that enhance operational efficiency and regulatory compliance.

> The most impactful solutions will feature a mix of data and IT integration, AI and GenAI technology implementation, and external solutions

Conclusion

The strategies explored in this whitepaper will allow depositaries to effectively navigate the complexities of the European regulatory landscape and achieve operational harmonization. Developing a cohesive target operating model for EU global depositaries is a challenging but attainable goal.

Depositaries that address key challenges and implement both straightforward and high-impact solutions can overcome barriers to regulatory compliance and operational efficiency.

This strategic alignment—combining standardized practices, innovative technology and strategic outsourcing—will not only boost customer service and revenue but also ensure consistent and efficient operations across the EU. This, in turn, will pave the way for a more unified and effective depositary sector.

Although this paper discusses EU alignment, many of the points apply in non-EU European jurisdictions such as the United Kingdom and Switzerland.

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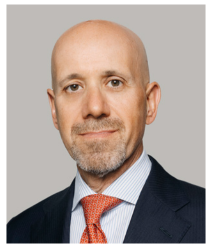

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