Settlement efficiency

ICMA PRMCMC Course

2022

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International Capital Market Association

What is settlement?
What is a fail?

- Per the ICMA repo guide to best practice, **settlement** is described as:
  - In order to successfully implement a transaction, **both parties** or their agents must send accurate and complete instructions for the **payment of cash and/or the transfer of securities** to their settlement institution in good time for those instructions to be matched and implemented on the **intended settlement date.** In the case of a **repo**, a settlement instruction from each party typically needs to be sent for **each leg**

- A **fail** is described as:
  - The failure by one party to a cash trade or repo to **deliver the full amount of securities** to the other party on the **agreed settlement date**. In a **repo**, failure to deliver can occur on the **Purchase Date** (the Seller fails) or on the **Repurchase Date** (the Buyer fails).

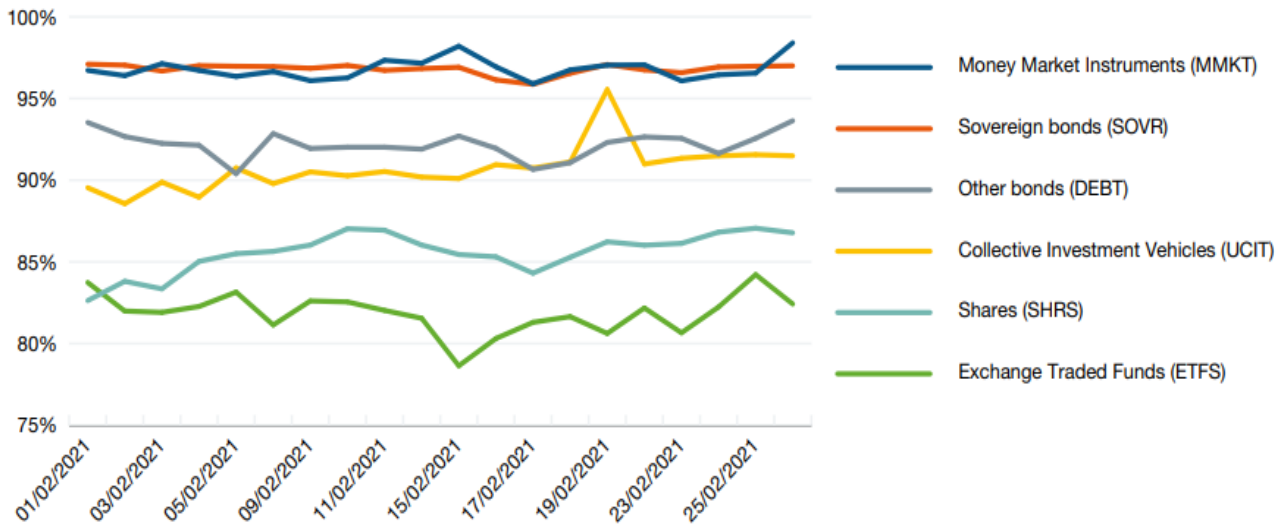
- Fails are problematic:
  - Cause **reputational** issues
  - Lead to **financial cost** (fail penalties, trading costs to cover fails)
  - Undermines ability to **move collateral** through the financial system
  - Can lead to a **loss of trust** amongst market participants

How big a problem are fails?

- Getting to a harmonized measure of fails is hard:
  - **Publicly available** information on fails is very **limited**
  - There is often no or little **distinction by transaction type** (e.g. Repo)
  - There can be many different ways to count settlement fails

- The chart* on the right…
  - Shows settlement rates by volume, by **asset class**, from February 2021
  - Sovereign and other bonds **include repo and cash bonds**, as there is **no distinction at the settlement level**
  - While rates of >95% (sovereign) and 90% (other bonds) appear high, **fail rates of 5% of more** in a European repo market sized at close to **€9.2 trillion**** are **significant**

Chart 3: T2S CSDR settlement efficiency per asset class (February 2021)[7]

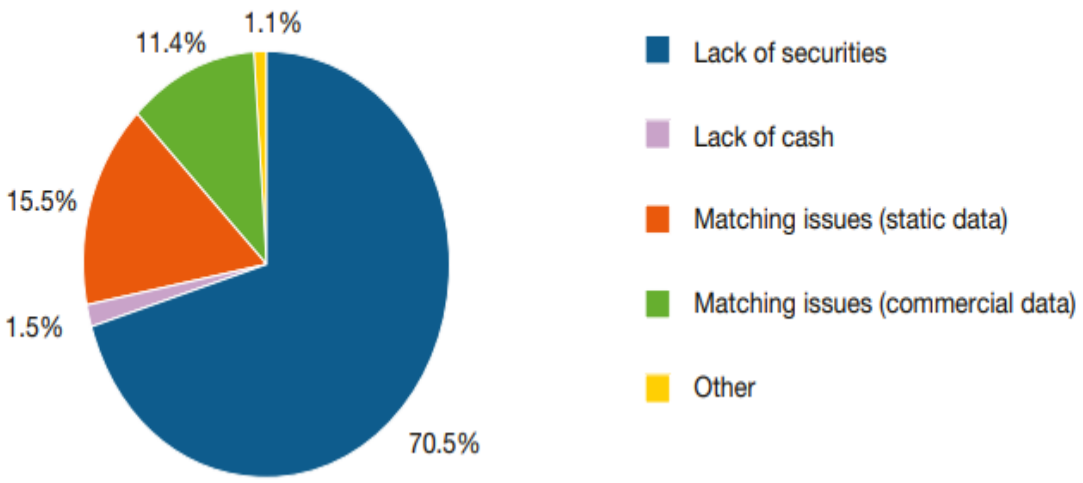


*Source: "optimising settlement efficiency", ICMA, 2022
** Source: ICMA Repo Survey, published April 2022

Why do fails occur in the repo market?

- The most common cause* for settlement fails
  - Is a **lack of** available securities to deliver
- Firms lack securities to deliver because
  - They are **failing to receive** securities themselves, causing a failing **settlement chain**
  - They are **unable to source** (borrow or buy) the securities they need to make delivery
- Other common fail causes include
  - A mis-match of settlement instruction **static data**
  - A mis-match of the **trade economics** agreed at execution

Chart 4: Main causes for settlement fails (ERCC settlement efficiency survey)



*Source: "optimising settlement efficiency", ICMA, 2022

CSDR Settlement Discipline: a brief overview

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- The EU CSD Regulation (CSDR) entered into force in 2014
- CSDR contains the **settlement discipline** regime, aimed at improving settlement rates across Europe **(note: UK markets not in scope)**
- The settlement discipline regime includes measures to improve **settlement efficiency**:
  - **Cash penalties**: where "failed settlements" trigger cash penalties.
    - For failed DVP settlements, the amount of cash penalty is calculated by:
      - *Penalty rate for security * Reference Price * quantity of failed delivery or receipt*
    - The **penalty rate** for Sovereign bonds is 0.1bps
  - **Mandatory buy-ins (MBI):** *a currently postponed* framework where there is a regulatory obligation for the party being failed to, to execute a buy-in (using a buy-in agent) within a set period of time. Under the regulation, SFTs under 30 business days [or less] in term are exempt.

MBIs were unpopular; associations successfully lobbied* for a postponement

We therefore believe that the implementation of the mandatory buy-in rules should be urgently disapplied through an appropriate regulatory mechanism that provides legal certainty to market participants. Subject to receiving the necessary clarifications, this should not affect the application in February 2022 of other appropriate aspects of the Settlement Discipline Regime that we believe will improve settlement efficiency in the EU, including cash penalties, where considerable progress has been made towards implementation.

MBIs postponed for 3 years, but the game's not over….yet!**

A combination of clarifying various elements related to settlement discipline (e.g. scope) and modifying the timeline for the implementation of mandatory buy-ins[33] ("two-step approach") is the most effective and efficient option. The implementation of mandatory buy-ins will be dependent on the evolution of settlement efficiency in the EU. First, the gathered evidence suggests that cash penalties will incentivise improvements in settlement efficiency, without endangering stability and liquidity across markets and financial instruments. Second, after cash penalties have applied, it can then be assessed how to best apply the mandatory buy-in in light of the evolution of settlement efficiency. The option to suspend the framework in its entirety was disregarded as settlement fails in the EU remain consistently higher than in other major financial markets.

*Source: joint trade association letter to the EC and ESMA, July 2021
** Source: EC publishes proposals for a revised approach to mandatory buy-ins, March 2022

CSDR: 2022 Developments

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- March 2022: European Commission published proposal for targeted revisions to CSDR, including mandatory buy-ins (MBIs).
- Notably, the Commission proposes a '**two-step approach**' to applying MBIs, based on an assessment of settlement efficiency for different markets.
- June 2022: ESMA published draft RTS proposing a 3-year delay to the implementation of the revised MBI framework.
- Currently the Commission proposal is being discussed by the Council and European Parliament.
- **ICMA continues to advocate for the full removal of MBIs from CSDR**.
- In the event that this is not possible, ICMA proposes **a number of refinements**, including **more flexibility for the two-step approach**, with the possibility to recalibrate penalties first, and the **explicit exemption of SFTs** from MBI scope.
- August 2022: the ECB published its opinion on the EC proposal, also supporting the removal of MBIs from CSDR. If MBIs remain, the ECB supports the removal of SFTs from scope.

ICMA's initiatives on settlement efficiency

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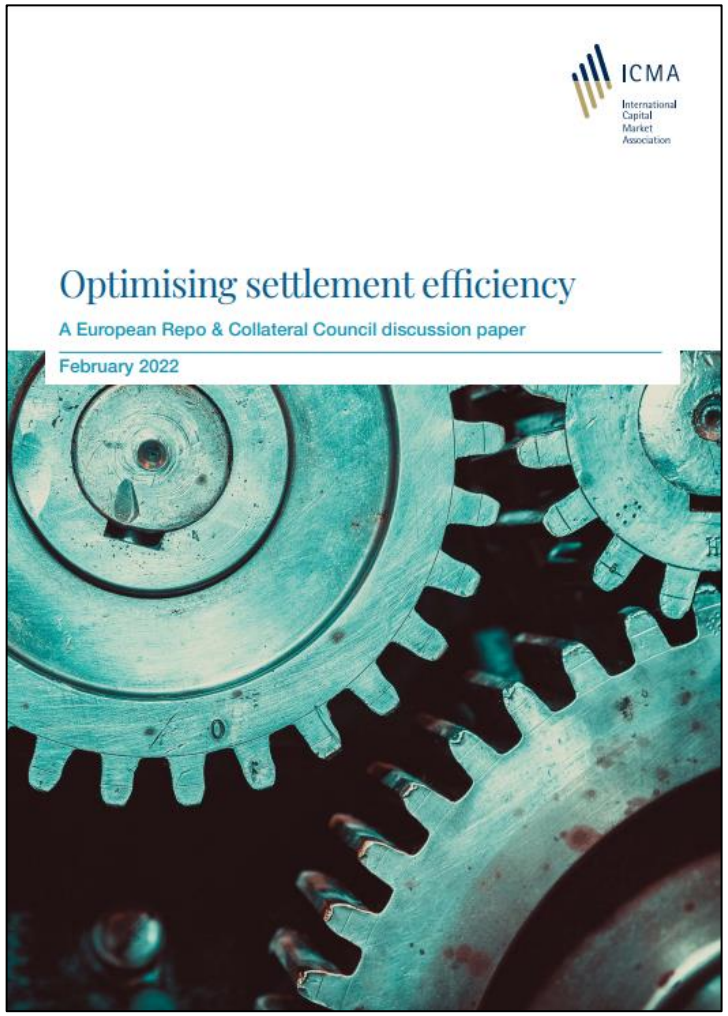
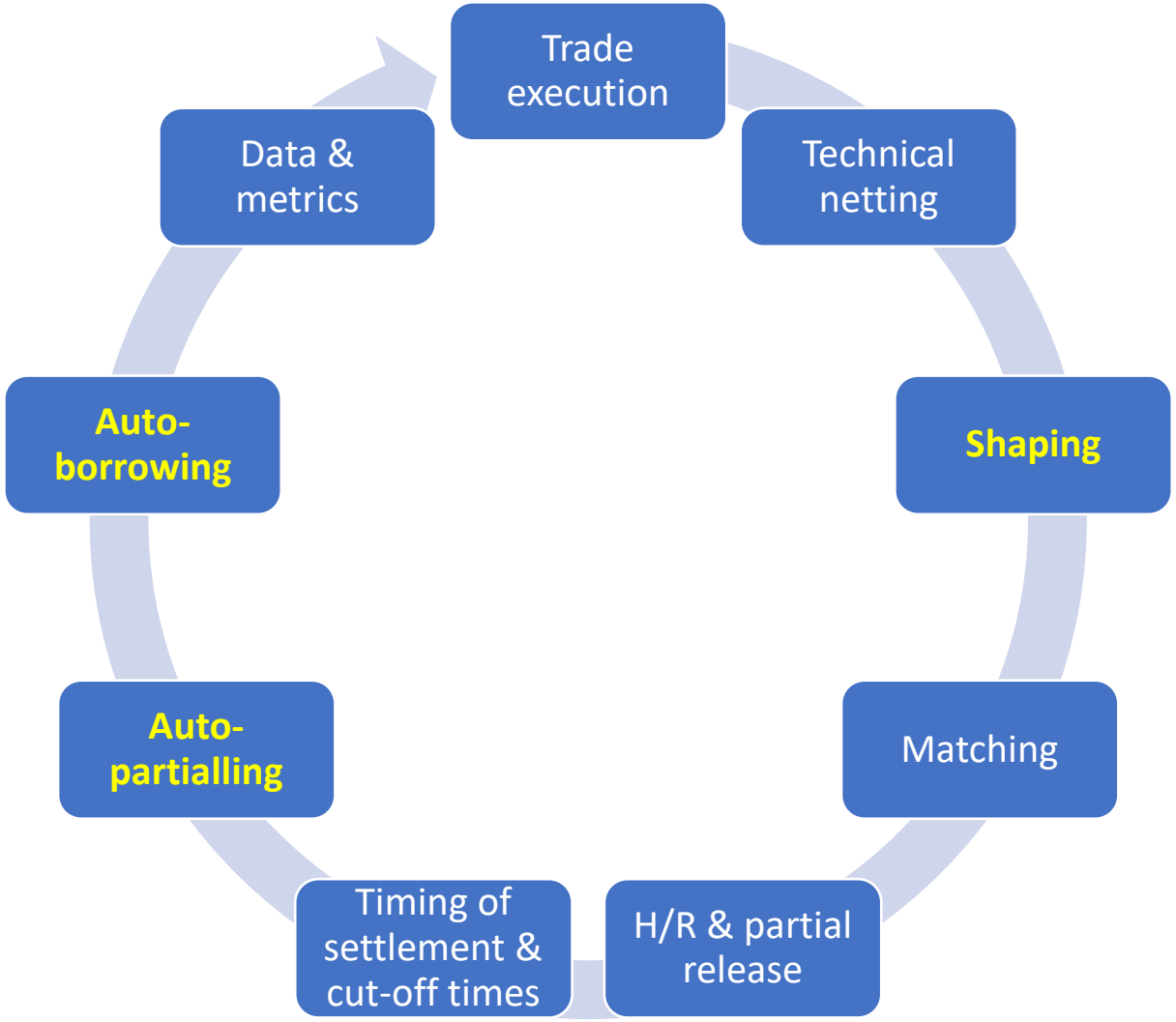
- Improving settlement efficiency and post-trade efficiency more generally has been a recurring theme for the ERCC over the past years
- In early 2021, in light of the upcoming implementation of CSDR settlement discipline, the ERCC launched an initiative to look at a number of relevant post-trade tools that are available to help the industry reduce number and impact of settlement fails.
- This led to the publication of the ERCC discussion paper *Optimising settlement efficiency* in February 2022,
- Paper consists of two main parts:
    - Assessment of the status quo in terms of settlement efficiency in Europe, mainly based on detailed analytical work prepared by the ECB's CSD Steering Group (and complementary data from ICSDs and CCPs)
    - A closer look at the key opportunities/tools that have been identified, namely (i) shaping, (ii) partial settlement, and (iii) auto-borrowing, focusing on current usage, remaining obstacles, and suggestions to encourage and optimise usage through best practice and other means.
- The paper was published alongside a compilation of existing ERCC best practices related to settlement efficiency
- In spring 2022, the best practices were also adopted by ICMA's SMPC group, which represents the cash bond community in Europe



Settlement efficiency drivers - overview



Best practices & discussion

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Relevant recommendations from the *ERCC Guide to Best Practice in the European Repo Market*:

Recommended delivery size (shaping) [2.70]	**Best practice recommendation**. It is best practice to divide instructions for the delivery of large amounts of collateral into 'shapes' *[of 50 million nominal value in EUR, GBP and USD, and the nearest equivalent in other currencies or the amount mandated or generally accepted in other currencies]* but confirmations should be sent for the whole transaction, not for each shape.
Partial delivery [2.71-2.79]	**Best practice recommendation.** It is best practice for partial deliveries to be accepted whenever there has been a delivery failure, provided that the party expecting delivery would not be disadvantaged by an incomplete delivery and provided that partialling is operationally feasible for both parties. Market users should make best endeavours to eliminate operational obstacles within their own firm and encourage customers to accept partial delivery. **Best practice recommendation.** It is best practice for partial settlement to be completed as swiftly as possible **Best practice recommendation.** It is best practice for parties to opt into the use of auto-partial facilities at CSDs. Auto-partial settlement should not be for less than the minimum tradeable amount in the market for the security being partially delivered.
Participation in auto-borrowing facilities at (I)CSDs [2.80]	**Best practice recommendation**. It is best practice for all participants in (I)CSDs to sign up as borrowers to auto-borrowing or automatic pool lending facilities and, where practicable, to sign up as lenders. As full use as possible should be made of these facilities.

ERCC initiative on settlement efficiency

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- Part of the assessment of whether MBIs will be introduced is how the industry performs on settlement efficiency
- Recommendations are good, but there is more that can be done….

Topic	Conclusions
Shaping	• Current best practice for repo to shape at EUR 50 million nominal – but as a manual process it is not widely applied **(except for CCP-cleared trades)** • Broad consensus that shaping should be introduced on an automatic basis in Europe • Discussion on the level at which shaping should apply, but still to be decided on “where” the shaping should take place, at the CSDs/ICSDs or trading venues
Auto-partialling	• Available in T2S, Euroclear Bank and Clearstream Banking Luxembourg, but usage is optional and remains sub-optimal • Automatically applied to CCP cleared trades, where participants have opted in • Key technical obstacle around omnibus accounts - further discussion and analysis with CSDs and custodians • ICMA is also looking to fully engage the buy-side and hedge fund community to explore ways to increase usage and address bottlenecks

Auto-borrowing	• Auto-borrowing programmes are seen as a key tool to support market liquidity and settlement efficiency
	• Still not available in all markets – but connections to some core T2S markets are being developed
	• Further discussion needed on three key aspects:
	  ○ How to strengthen the rules around the use of auto-borrowing, where appropriate
	  ○ How to incentivise borrowers and lenders to sign up and actively use auto-borrow
	  ○ How to extend coverage of the auto-borrow programmes to markets where this tool is currently not available