ICMA Secondary Market Practices Committee

Best practices in support of settlement efficiency

June 22, 2022

Context

The following secondary market best practice in support of settlement efficiency is intended to be applied by ICMA members in the context of the international securities. These best practice recommendations have been developed through the work of ICMA European Repo and Collateral Committee (ERCC) and the ERCC Operations Working Group. The ERCC Committee endorsed this list of best practices at its meeting on 25 January 2022, highlighting the commitment of member firms to follow these recommendations for the benefit of the wider market and to encourage other firms to do the same.

The best practices below are based on those extracted from the ERCC Guide to Best Practice in the European Repo Market which are deemed most relevant in the context of bond market settlement efficiency. They are also proposed in reference to the ERCC’s discussion paper: Optimising Settlement Efficiency to draw particular attention to existing best practices on the topics covered in the paper, including: (i) Shaping of settlement instructions, (ii) Partial settlement and auto-partialling, (iii) Auto-borrowing, and (iv) Other relevant issues (netting and recommendations related to settlement instructions).

These best practice recommendations should also be viewed in the context of the EU’s CSDR Settlement Discipline regime. While a penalty mechanism for settlement fails has already been introduced, the Commission has proposed that a mandatory buy-in regime could be applied to certain markets at a future date in the event that settlement efficiency rates do not see an improvement.

Following consultation with members, the proposed best practice recommendations are as follows:

1) Shaping

**Best practice recommendation.** It is best practice to divide instructions for the delivery of large trade ‘shapes’, but confirmations should be sent for the whole transaction, not for each shape.

It is best practice to divide or ‘shape’ instructions for the delivery of a large trade sizes into smaller deliveries or ‘shapes’ so as to limit the economic impact of settlement failures and help reduce the consumption of intraday liquidity. Accordingly, it is recommended that parties in the international bond markets agree to shape transactions into multiple deliveries 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. Note that shaping does not break up a transaction into smaller contracts. It is a purely operational process. Accordingly, confirmations (which are post-trade but pre-settlement verifications) should be sent for the whole amount transacted, not separately for each shape.

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1 For the purposes of ICMA’s rules and recommendations, an international security is a security intended to be traded on an international cross-border basis (ie between parties in different countries), and capable of settlement through an international central securities depository or equivalent.
2) Partial settlement

**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. Partial settlement should not be for less than the minimum tradeable amount in the market for the security being partially delivered.

Where a Seller has failed to complete full delivery to the Buyer on the Intended Settlement Date, it is very desirable that the party expecting to receive the delivery should accept partial delivery. Such ‘partialling’ reduces the economic impact of fails on the counterparty as well as on the liquidity of cash and repo markets. It also mitigates the cost of penalties for failed settlement.

**Best practice recommendation.** It is best practice for partial settlement to be completed as swiftly as possible.

Where partial settlement remains a manual process, parties should aim to complete the process 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.

(I)CSDs may offer automatic partial settlement facilities, commonly called ‘auto-partial’ facilities. Auto-partial facilities automatically identify the availability of securities for partial settlement when full settlement has failed and optimize and implement such settlement. As an automatic process, auto-partialling enhances the efficiency of settlement across the market. It is therefore best practice to opt into such facilities where they are offered. Where a party does not opt to use auto-partial facilities, they should make this clear to their counterparties and explain their reasons. Settlement agents should actively encourage their clients to allow use of auto-partialling for the settlement of their instructions. Where parties have the choice, auto-partial settlement should not be for less than the minimum tradeable amount in the market for the security being partially delivered.

3) Auto-borrowing

**Best practice recommendation.** With the exception of CCPs, 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.

The two ICSDs and some CSDs operate auto-borrowing or automatic pool lending facilities. These are pools of securities made available for lending by participants to fill complete or partial shortfalls where sellers have insufficient securities to meet their delivery obligations. Lenders earn a share of the fees charged to borrowers. Fees tend to be higher than in the securities lending market in order to discourage over-reliance on these facilities at the expense of internal settlement efficiency.
Participation as a lender or a borrower is voluntary. The (I)CSDs typically indemnify lenders and take liens on the securities accounts of borrowers. Lending is anonymous and subject to limits related to holdings. Auto-borrowing plays a key role in reducing settlement failures but its efficacy depends on participants signing up to these facilities as both lenders and borrowers. It is desirable for all CSDs to offer auto-borrowing facilities. It is best practice for all participants in the international bond markets to sign up as borrowers to such facilities and, where practicable, for participants to sign up as lenders. As full use as possible should be made of these facilities.

In the case of CCPs, it may not be appropriate to use auto-borrowing and pool lending facilities, as these could be inconsistent with their risk management models.

4) Technical netting or ‘pair-offs’

**Best practice recommendation.** It is best practice for parties to co-operate to maximize both bilateral and multilateral netting opportunities. This includes the use of pair-offs between related bond and repo transactions to reduce settlement cost and risk.

An important example of netting to reduce the cost and risk of settlement is the ‘pair-off’. This includes the action of netting instructions for a bond transaction with a simultaneous repo or reverse repo transaction (that are not managed by a tri-party agent) where those transactions are with the same counterparty, of the same currency, against the same security held at the same custodian or depository, by agreement with the counterparty to eliminate or reduce the cash payments and securities transfers required for settlement. Pair-offs can be between multiple instructions.

Pair-offs require the agreed and coordinated cancelation of the original settlement instructions and the issuance of new instructions for net payment.