



**An update on reform of market infrastructure
in Italy and Greece
since the ERC white paper of 13 July 2010**

25 March 2011

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1 Introduction

- 1.1 In July 2010, the ICMA's European Repo Council published "A white paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure".¹ Among other things, this document highlighted concerns among market users about the persistence of barriers to interconnectivity between the ICSDs and the domestic CSDs in Greece, Italy and Spain. These barriers have undermined the efficiency of cross-border transfers of securities, fragmented the European financial markets and exacerbated the impact of the recent crisis. They have remained in place despite many years of strenuous effort to create a single European financial market.
- 1.2 The ERC White Paper was updated in December 2010.² This document sets out subsequent responses by the Greek authorities and the Italian CSDs, and summarises progress since July 2010 towards the elimination of the identified barriers to interconnectivity. There is nothing further to report on Spain.

2 Italy

2.1 The problem

- 2.1.1 Long-standing concerns over obstacles to interconnectivity between the Italian CSD and the ICSDs were accentuated by a dramatic increase in delivery failures on transactions (mainly repos) cleared through the international CCP, LCH.Clearnet, during 2009-10, but not those cleared through the domestic CCP, CC&G. The problem appeared to coincide with the start of same-day transactions in CCP-guaranteed repos in November 2009 and was widely attributed to this initiative, although other commentators argued that the surge in fails reflected market turbulence and short-selling by international investors, who mainly clear through LCH.Clearnet. The latter argument highlights an institutional fault line across the Italian securities market caused by the lack of securities lending by domestic institutions, who are the predominant holders of Italian government securities, to international investors, who are frequently the most active users.
- 2.1.2 Following the harmonisation of most settlement shaping sizes, there has been a significant reduction in delivery failures cleared through LCH-Clearnet, from a peak in May 2010 of almost 11% (in terms of value and

¹ The White Paper can be accessed via: <https://www.icmagroup.org/ICMAGroup/files/ac/ac9739eb-6c8b-4d0f-9f5c-d0f13e89bd8e.pdf>

² The Update can be accessed via: <https://www.icmagroup.org/ICMAGroup/files/2a/2a675b39-78b2-4697-8ab9-3471cd6fe179.pdf>

including delivery failures rolled over from previous days) to less than 2.5% in August 2010 (although the percentage has risen since).

- 2.1.3 The fundamental barrier to interconnectivity with Italy seems to arise because the various settlement cycles at the CSD are not fully integrated. Once instructions are passed from the daytime batch-processing cycle into RTGS, if they fail, they remain in RTGS and are not recycled on into the overnight batch-processing cycle, where they could be cancelled against matching instructions. Furthermore, because RTGS lacks both a technical netting functionality and a bilateral facility for users to fix unsettled instructions by mutually-agreed correction, amendment or cancellation, such instructions accumulate within RTGS for up to 10 days, increasing credit exposures and delaying buy-in's, thereby amplifying the cost of failing.
- 2.1.4 There is concern that the difficulties posed by RTGS result in the concentration of settlement in the overnight batch-processing cycle (96% by number of instructions, 80% by value). The CSD has argued that the concentration of settlement in the overnight batch-processing cycle was a sign of settlement efficiency, but recognised best practice is for settlement to be spread across all cycles.
- 2.1.5 The build-up of unsettled instructions in RTGS has a number of adverse knock-on effects. One of these is the requirement by local custodian banks for very early telephone pre-matching of settlement instructions in order to validate instructions before they are submitted to the CSD. Telephone pre-matching delays the start of settlement and compresses the business day.
- 2.1.6 The effective settlement window is compressed at the end of the day by: (1) access to the RTGS between 16:10 and 18:00 CET being reserved for local custodians; (2) the lateness of settlement reports from the overnight batch-processing cycle; and (3) the late finality of the daytime batch-processing cycle (13:15 CET). Reduced access, late reports and late finality do not give users sufficient time to arrange re-use of their securities.
- 2.1.7 The CSD used to specify different shape sizes for CCP and OTC transactions. In 2010, the CSD harmonised shaping at EUR 5 million for all CCP and OTC transactions, except same-day CCP transactions. As noted, this seems to have had a significant impact on fails. However, some users also wish to see the shaping of the opening leg of same-day CCP transactions. This has been impossible to date, as the opening leg of these transactions is settled in RTGS and the closing leg in the batching-processing cycles.
- 2.1.8 Concern was expressed in the White Paper about the blurring of functions between the CSD and CCPs, as netting calculations are performed by the CSD, which passes the results to the CCPs. However, the CSD has explained that the CCPs are outsourcing only settlement and payment netting calculations to the CSD, and that the CCPs continue to perform risk netting calculations independently.

2.2 Initial response from the CSD

2.2.1 The CSD stated that it provided tools that allow users to perform early matching of transactions by using segregated accounts (Conte Liquidatori) for each customer. However, it is unclear whether this is a practical solution.

2.2.2 It was originally argued that a settlement report issued at 07:00 CET (ie 7:00 am) on settlement date (S) provided users with sufficient information to be able to arrange re-use of their securities. The 07:00 deadline is apparently the time stated in the CSD user manual but the actual time of publication was 00:00 (CET). However, even this was regarded by many users as too late.

2.2.3 The CSD clarified that late access was restricted to all direct participants/clearing members (not just local custodians) and argued that the cut-off time of 16:10 compared well with other settlement systems.

2.3 Latest response from the CSD

2.3.1 In October 2010, the CSD informed the ERC of plans for a fundamental upgrading of the Italian settlement process in two stages in 2011 in anticipation of the introduction of T2S in 2014. These plans had the potential to resolve many of the existing barriers to interconnectivity between the CSD and the ICSDs:

- The abolition of the daytime batch-processing cycle by the end of 2011, so that only RTGS would operate during the day. Moreover, unsettled instructions would be recycled from the RTGS into the overnight batch-processing cycle, where they could be cancelled against matching instructions. This change could resolve many of the interconnectivity issues raised in the White Paper.
- A clutch of new facilities that could improve settlement efficiency and would remove the need for telephone pre-matching.
 - A technical netting (*optimisation*) facility in RTGS by the end of 2011.
 - A bilateral facility by June 2011 to allow users to cancel unsettled instructions in RTGS.
 - A *hold-and-release* facility for OTC transactions by June 2011.
 - A facility to match instructions at the level of each client and not just for the clearing member/direct participant.

2.3.2 The CSD's proposals did not include the extension of auto-collateralisation (self-collateralising repos) from the overnight batch-processing cycle into RTGS, largely due to circumstances which the CSD said was beyond their control.

2.3.3 Following a meeting with major clients in December 2010 and a management re-organisation, the plans of the CSD have become fluid and it is no longer clear whether the upgrade outlined in October 2010 will now be carried out. Given the short interval until T2S, the suggested changes were not seen as cost-effective. Clients were also concerned that the changes might not be compliant with T2S and would have to be modified closer to the

time of its introduction. A working group has been formed with customers to decide the order of priorities and draw up a strategic “road map” towards T2S, which the CSD will join in the “first wave” of the system’s implementation. It is hoped that a clearer picture will emerge by the middle of 2011.

2.3.4 A triparty repo service and collateral management functionality will be introduced by the CSD in September 2011.

2.3.5 The CSD has clarified that it in fact issues settlement reports by 22:00 on S-1. The CSD believes that delays in the receipt of the results of the overnight batch-processing are due to custodians. One ICSD has confirmed that the “technical limitations” of its sub-custodian prevents the ICSD from forwarding reports of settlement results before about 06:00.

3 Greece

3.1 The problem

3.1.1 Liquidity in the market in Greek government securities has been severely constrained by chronic barriers to interconnectivity between the CSD and the ICSDs, the unforeseen consequences of the attempt to impose settlement discipline through the imposition of a punitive compulsory buy-in mechanism and the underlying illiquidity of securities lending. These problems have been exacerbated by the Greek sovereign debt crisis, which has fragmented the market by isolating the domestic banks who are the principal holders of Greek government securities.

3.1.2 The underlying interconnectivity problems include:

- The practice by custodian banks of pre-matching settlement instructions by telephone or exchange of files. This results in custodians releasing settlement instructions to the CSD only on the settlement date and only if they are certain of delivery. Pre-matching is not an official requirement but appears to have been adopted by custodians following the introduction by the CSD of a centralised repo auction which forced buy-ins at punitive prices on sellers of Greek government securities who fail to deliver. This “forced auction” takes place at 15:00 CET on the domestic electronic trading system, HDAT. The forced auction may have artificially suppressed delivery failures and thereby overstated the true efficiency of the CSD, as local custodians will not enter instructions into the CSD for cash or repo transactions unless they are certain of delivery. The CSD discontinued the forced auction in February 2009, but pre-matching by custodians continued. The forced auction was re-activated in April 2010, although only for delivery failures on HDAT (which consequently suffered a sharp loss of business). However, the pre-matching of OTC (ie non-electronic) transactions persists, reportedly because of procedural inertia and the risk that a delivery failure in an OTC transaction could cause an onward fail in an electronically-negotiated transaction. The CSD opened discussions with local agent banks to encourage them to

abandon pre-matching and offered to consider alternatives such as a “hold-and-release” mechanism, but no progress has been reported.

- The use of omnibus accounts by some local custodians. The opacity of such accounts may encourage custodians to hold back from entering settlement instructions until securities are known to be available in order to prevent the inadvertent use of holdings of securities belonging to the wrong client.
- The lack of an overnight batch-processing cycle, which means there is no opportunity before or early on the settlement date to validate and match settlement instructions, and identify and fix potential delivery failures, or to match and net off opposite transactions in order to reduce settlement volume and improve settlement efficiency. In November 2009, a facility was introduced by the CSD which recycled failed instructions to the next settlement date for up to 10 days. This initiative came under political attack, on the pretext that it was facilitating short-selling of Greek government securities. In the event, recycling was not effective due to the underlying scarcity of securities.
- The shortness of the settlement cycle. The CSD is open from 07:00 to 14:30 CET (local time is CET+1), but the effective settlement window is much shorter, because:
 - There is a lack of liquidity in the system during the first two hours of the morning session, apparently due to the reluctance of custodian banks to pay cash into the RTGS process early in the day. Consequently, most settlement takes place after 09:30 CET.
 - For electronic transactions, the settlement window closes earlier because of the deadline imposed by the Hellenic Banking Association (HBA), which represents all custodian banks, in order to meet the CSD deadline of noon CET (compared to 14:30 CET for OTC transactions). This leaves little time to input settlement instructions and even less time to resolve potential delivery failures, as well as tying up securities and precluding their re-use for cross-border transactions.
 - The CSD had agreed to start settlement at 20:00 CET on S-1 but this has yet to happen.
- The concentration of settlement of OTC instructions --- accounting for about 15% of total settlement --- at the end of the settlement day. This may reflect liquidity problems at Greek banks, which cause them to delay settlement as long as possible, and the early close of the CSD for electronic transactions, but could also be due to custodians giving priority in collateral allocation to electronic transactions, because these are subject to the forced auction.
- The lack of shaping of settlement instructions. Although transaction size is currently small, this issue will become increasingly important as the market develops.

3.1.3 During the Greek sovereign debt crisis, the local repo market seized up. The simultaneous collapse in the credit of Greek counterparties and the Greek government raised the spectre of “wrong way risk” in the repo market for Greek government securities (the positive correlation between the credit risks of repo counterparties and the issuer of collateral securities). Greek

banks --- the main holders of Greek government securities --- have been effectively isolated as borrowing counterparties, so primary dealers have been unwilling to quote for fear of going short, which has severely damaged repo and cash market liquidity. The collateral famine may have been made worse by the diversion of Greek securities into the ECB as collateral to access central bank liquidity.

3.1.4 In the White Paper issued in July 2010, the ERC outlined a number of suggestions to release the pool of securities trapped in local custodian banks or rendered inaccessible because of credit objections to Greek counterparties, including:

- A standing repo facility for primary dealers at the Greek debt management office (PDMA) or Bank of Greece along the lines of the facilities offered by the debt management agencies in Belgium, Netherlands, Portugal and the UK, lending temporary issues of securities which are scarce in the market (phantom/synthetic bonds). This would relieve the illiquidity of the Greek market and remove the need for the forced auction. An alternative in the form of a bond exchange was also mooted.
- Interposing a CCP in a reformed daily repo auction to clear unsettled short positions. However, as credit issues would prevent Greek banks gaining access to an existing CCP, it was suggested that the PDMA act as a credit intermediary. Market users appeared to be willing to accept Greek sovereign risk in order to resolve settlement problems. It was generally accepted that the implicit borrowing fee needed to be high, in order to attract securities lenders (repo sellers), but only if the fee was capped and not disproportionate (in contrast to the forced auction). Initial suggestions were for a fee of 5-10%.
- Encouraging the ECB to recycle the Greek government securities that it is holding back into the market (while recognising that the ECB only has the power to recycle the securities that it has purchased since May 2010).

3.2 Initial responses

3.2.1 The HBA refused to extend the deadline for the settlement of electronic transactions to 13:30 CET because of unspecified operational reasons.

3.2.2 The CSD agreed to consider an extension to the settlement day, but has been waiting to see if earlier settlement instructions would help. It appears that the start of settlement has still not been brought forward to 20:00 CET on S-1.

3.3 Latest responses

3.3.1 In December 2010, a delegation from the ERC and AFME/EPDA met with the Greek Public Debt Management Agency (PDMA) to “brainstorm” about possible solutions to the current market impasse. Topics included:

- an overnight repo facility to lend synthetic (ie temporarily issued) securities to primary dealers

- a bond exchange auction to relieve illiquid sectors of the yield curve
- the provision of timely information by local custodians to market users on their holdings within omnibus accounts
- easing liquidity shortages, particularly those during the first two hours of the settlement day, through the provision by the CSD of self-collateralisation (ie the automatic mobilisation of a member's holdings of idle securities as collateral for the automatic borrowing from the CSD of funds or other securities needed to ensure settlement which would otherwise be held back until inward delivery can be confirmed)
- provision for the shaping of settlement instructions to mitigate the impact of delivery failures
- freedom of choice of interdealer trading platform for market users and full competition between platforms
- the relaxation in situations of unusual volatility of quoting obligations on HDAT (ie wider bid/offer spreads) in order to prevent complete market closure
- regular meetings between the PDMA and CSD on the one hand and primary dealers, EPDA and ERC on the other.

3.3.2 The ERC is awaiting confirmation that its proposal for an overnight repo facility has been submitted to the Greek parliament.

3.3.3 Earlier this month, the PDMA announced to its market committee that the penalty for delivery failure imposed in the forced auction will, in the near future, be capped, by limiting the repo rate in the auction to a minimum level of -7%, subject to approval by the Ministry of Finance and the central bank.

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