Aged-Fails Auction Initiative

An initiative of the ICMA Secondary Market Practices Committee
February 2016
Background

- The ‘aged fails auction’ is a market driven initiative to improve settlement efficiency in the European fixed income markets.

- It is intended to provide an alternative source of liquidity for market-makers who are looking to cover short positions that are failing as a result of a lack of liquidity in the secondary bond or repo markets.

- The initiative is designed to connect dealers running aged fails in specific securities to holders of those securities who are provided with the opportunity to tender the securities through a standardized auction process.

- Holders of relevant securities will be notified of tender interests by means of (I)CSD corporate actions messaging functionality.

- This will help dealers to manage their risk more effectively, and to avoid the inherent costs of failing a short-sale transaction, including the risk of being bought-in.

- It is intended that the auction process can be adapted into a ‘buy-in auction’ mechanism.

- In realizing the initiative, ICMA is happy to work with any interested platform or MTFs, helping to connect them with its sell-side and buy-side members, as well as the (I)CSDs.
Proposed mechanism

- The initiative is designed to leverage existing infrastructure and automated processes, with minimal investment and development work.

- The underlying concept is that participating MTFs or trading venues will provide regular ‘aged fails auctions’, on a designated day and time, at which dealers can attempt to cover specific short positions that are failing, or in risk of being bought-in.

- Dealers will provide the chosen participating MTF or trading venue with details of the security or securities they wish to bid for on the auction by a specific notification date.

- The MTF or trading venue will then provide the details of the securities to be included in the upcoming auction to the international central securities depositories (ICSDs), who will utilize their corporate actions notification mechanisms to inform holders of the relevant securities of the upcoming auction.

- This will provide holders with the opportunity to tender securities (for guaranteed delivery) to the failing dealer via the MTF’s or trading venue’s auction mechanism.
Proposed mechanism

Information flows
Security flows
Considerations

- How frequently should auctions take place?
- What should be the deadline for notification of interests?
- What should be the method of communication with the (I)CSDs? SWIFT?
- What is the optimal auction process?
- What should be the price formation process?
- Should there be price guidance?
- How to ensure/enforce guaranteed delivery?
Commercial viability: identifying the need

- In 2014, ICMA conducted a ‘settlement efficiency’ survey of its sell-side members. Respondents represented around 30% of the European fixed income market.

- The survey suggests that on T+4 around 6,000 fixed income transactions are unsettled, of which around half are corporate bonds.

- By ISD+10, almost 900 trades from the survey population are still unsettled, of which more than 80% are corporate bonds.

- In 2015, ICMA surveyed its sell-side members to ascertain better the likely demand.

- The responses (15) suggest that:
  - There is broad support, although most would only expect to use the auction once or twice a month (but this demand should increase with CSDR mandatory buy-ins)
  - Most demand would be for IG and HY credit, as well as EM
  - Ticket-sizes are likely to be less <EUR 5mm
Commercial viability: survey results

- How frequently do you envisage using the auction mechanism?

![Frequency of auction usage bar chart]

<table>
<thead>
<tr>
<th>Frequency (per month)</th>
<th>Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-2 times</td>
<td>7</td>
</tr>
<tr>
<td>3-5 times</td>
<td>4</td>
</tr>
<tr>
<td>6-10 times</td>
<td>3</td>
</tr>
<tr>
<td>&gt; 10 times</td>
<td>2</td>
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</tbody>
</table>
Commercial viability: survey results

- For which markets do you anticipate using the auction mechanism?
Commercial viability: survey results

- **What transaction sizes do you anticipate executing in the auction?**

![Bar chart showing ticket size preferences](image-url)
Commercial viability: survey results

- Do you think that the introduction of CSDR settlement discipline (mandatory buy-ins and cash penalties for fails) will increase the likelihood of you using such a mechanism?

<table>
<thead>
<tr>
<th>Response</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Yes, significantly</td>
<td>53%</td>
</tr>
<tr>
<td>To some extent</td>
<td>47%</td>
</tr>
<tr>
<td>Not particularly</td>
<td>0%</td>
</tr>
</tbody>
</table>

Respondents
Commercial viability: survey results

- To what extent would you be interested in the development of a platform based buy-in auction mechanism as an alternative to the current OTC buy-in process?

**Respondents**

- Very interested now: 40%
- More interested post-CSDR: 53%
- Not particularly: 7%
A buy-in auction mechanism

- It is intended that the Aged-Fails Auction mechanism becomes a prototype for a Buy-in Auction mechanism.
- CSDR settlement discipline, including mandatory buy-ins, is likely to be introduced in early 2018.
- The final RTS for mandatory buy-ins are expected in early 2016.
- A study by ECSDA (2015) suggests that based on current European settlement efficiency rates, mandatory buy-in regulation would prompt 7,500 buy-ins to be triggered every day: that’s 1.8 million per year, with an underlying market value of over €2.5 trillion.
- Over the course of 2016 ICMA intends to revise its OTC buy-in rules to support a buy-in auction process.
Contact

Andy Hill  
andy.hill@icmagroup.org  
+44 (0)20 7213 0335

Alexander Westphal  
alexander.westphal@icmagroup.org  
+44 (0)20 7213 0333

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