Securities Finance and CSDR

Don't fail to deal with fails

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Introduction

The securities finance industry faces potential costs of around €300 million a year due to fines that will be imposed by the Central Securities Depositories Regulation (CSDR). The complexity of attributing these fines and managing claims between firms will likely present significant challenges to the industry. In this paper we consider recent research undertaken at Pirum to understand the impacts, but more importantly what firms should be doing around fails management to mitigate these.

In the UK, the chancellor of the exchequer announced on 23rd June 2020 that the UK does not intend implementing the regulation into EU law and would consult with the industry on any future legislative requirements, whilst the EU set a new go-live date for February 2022. Firms are now pushing ahead with their preparation. Regardless, firms advise us that regardless of the actual go live date, they see huge benefit that the improved settlement discipline will have in reducing risk and improving cost management. So, whilst there are additional costs of CSDR, the overall aim of improving fails management will benefit firms in the long-term.

The expected exclusion of securities finance trades from the buy-in regime also has not materialised. The industry is now preparing for the buy-in regime to be in force when the regulation goes live, although there is working assumption that any exclusion from this will be implemented post go-live.

Of course, fails management is currently part of the settlement process across securities finance transactions, however unlike the cash or 'normal' settlement markets, there are some unique features within securities finance that will likely have an adverse impact.

Firstly, the value of transactions tends to be significantly larger than their cash equivalents. Secondly, settlement cycles tend to be shorter, and it is not unusual to book transactions hours before settlement, if not right up to market settlement cut-offs. This is driven by the need to cover positions with short notice and also to mitigate the impact of failing trades elsewhere in the firm – often caused by failing to receive securities on the back of a cash trade. So, although CSDR is a challenge to securities finance, securities finance is very much part of the solution for CSDR.

Pirum is in a unique position within the industry, as it reconciles transaction data across $2.5 trillion of securities finance transactions, including Securities Lending, Repo, and the associated collateral for cash, bilateral and triparty trades.

Real-time reconciliation allows firms to see the settlement status of trades, along with the aging of any fails. As a result, Pirum is able to calculate the potential fines associated with market fails, along with analysing their root-causes.

In recent Pirum research, we found that the cost of firms managing these fails amounts to around €85million for the industry annually today. This is driven by exception management processes, re-processing costs (such as agent and swift costs) and the head count required to manage this. Whilst there is a significant problem, with around 5% of trades failing for one day or more (see figure 1), firms that leverage real-time pre-matching and lifecycle event automation already significantly outperform market participants that do not.

When we overlay the potential CSDR fines these fails would attract, the cost would be in the region of €80-110million annually. Significantly, nearly two-thirds of those costs are caused by the return or off-leg of the transaction (See figure 2). This represents the challenges firms have at keeping trade and cash values in line where appropriate and managing the communication of closing out the positions through termination / maturity of the off leg for repos and stock loan returns.

fig 1. Fails Rate

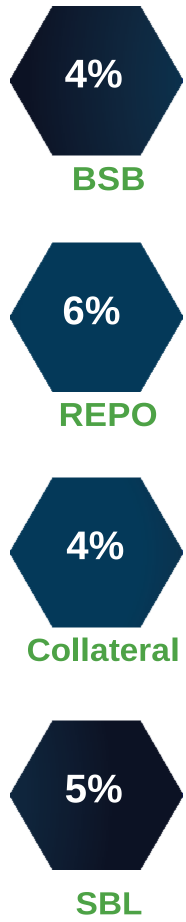
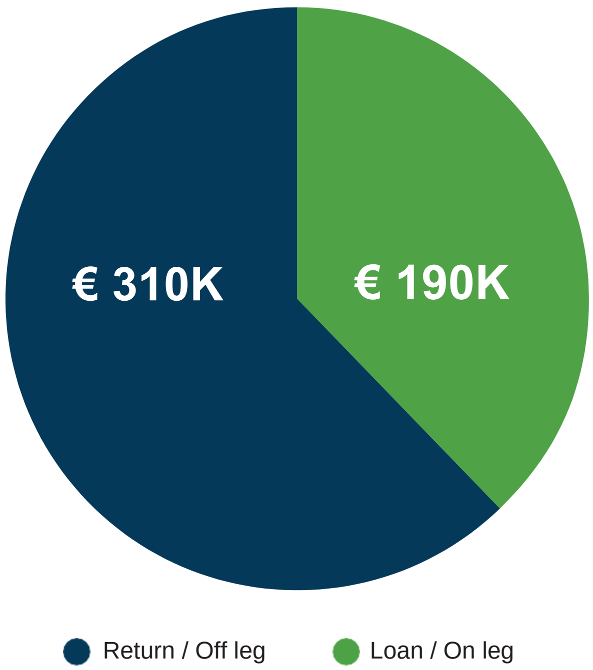


fig 2. Average daily fines by activity



Who carries the cost?

CSDR fines will need to be paid by the party that causes the fail. The CSD will calculate and charge the party that they see as causing the fail, although in reality this may not be the party that is responsible, so firms can and should pass on the fine to the counterpart or even their underlying client where applicable. This means there needs to be an effective mechanism for fines management – identifying the party that has caused the fail and efficiently agreeing this and passing on the cost and making the payment. We estimate that this could cost the industry a staggering €120-200millon annually through direct fines, additional processes, systems, and resources required to manage it all.

The total potential cost impact of CSDR on the industry will be in excess of €300million annually – which is certainly an incentive to improve what is happening today.

> €300 million cost annually

In addition, the industry also needs to assess the impact of the mandatory buy-in regime and how the 30- day rule applicable to securities finance will impact them, given that this I also expected to now be implemented in February 2022.

Another factor to consider with CSDR, is that the settlement regime and processes will be harmonised across the Europe CSD network. This should result in increased information available for firms to manage fails, and additional functionality such as auto partialling as standard. This should help firms deal with some of the fail's regime, but will also need to be factored in to how teams deal with processes and interactions with their custodians and ultimately the CSDs.

What's causing the problem in the first place?

Fails are caused by various factors, the most common are:

Data sharing

It is still common for firms to share SSIs via PDF documents, and most often they don't follow industry best practice standards. There are also particular challenges with agency lending and repo – where multiple SSIs are used to represent the underlying allocation. Often, firms do not provide SSIs for automated reconciliation at the trade level which means operations teams either must manually pre- match each transaction or rely on investigating the fail once it has happened.

Lack of transparency

Firms struggle to get a consolidated view of their fails information in order to assess both the impact of the CSDR regime and aid root cause analysis. Additionally, settlement related data either is not captured or needs to be viewed across various systems – this is particularly prevalent in the fixed income / repo market with the use of contractual settlement within trading systems rather than having a comprehensive view of actual settlement.

Low automation

From manual input & enrichment of trades, no exception management and workflow tools, along with multiple sources and uses of information. Users are required to proactively investigate issues, leading to reactive settlement management, and where there are spikes in volumes, stressed situations, or short settlement cycles this exacerbates issues. In addition, whilst it is common to use affirmation and confirmation processes, the matching status of trades is not then automatically used to release market instructions to custodians – leading to mismatching settlement instructions.

Lack of controls

Controls around data management, data enrichment and manual processing are often inadequate, and it is only when problems occur that issues are raised. Then when the crisis is over, these are never revisited and resolved adequately. The processing of life-cycle events, particularly around fund switches by agent lenders and returns processing has a significant impact on fails – and these are often manual processes that can easily be missed.

Rooting out the cause

It goes without saying that firms need to spend some time and effort on firstly, identifying where they are having problems, and secondly understanding what the impact will be to prioritise what to tackle first.

Having a clear understanding of your fails across markets and product types, such as which leg of the transaction is causing issues (on or off leg) along with an understanding of the impact CSDR fines will have, is important. It is also vital to both age and value fails to prioritise what needs to be investigated first and categorise issues.

Additionally, firms need to look at the impact of life-cycle events on the settlement process more broadly. There are around 35 life-cycle events across securities lending and repo trades and 26 of these have a potential settlement impact, with many types of corporate actions also creating settlement events too. It is very important to not just look at what happens at the start and end of a trade - the new loan and return or the on /off leg of a repo, but also other events and their impact, from marks to fund reallocations.

Overlaying the fails with the relevant CSDR fines will then allow you to understand both the daily and accumulative fails costs, so you can see both where large costs will build up along with the velocity in resolving these.

Checklist

1. Identify & capture your fails over a period, and age these appropriately
2. Identify the core parameters that you want to analyse – e.g. market, product, trade type, trade leg, client / client type, liquidity
3. Understand what processes and lifecycle events impact or create settlement events
4. Overlay the CSDR fail penalty costs
5. Establish the root cause of fails by categorising the fail and the cause
6. Understand if the causes are unique to your firm or are similar to your peers'

Fixing the operating model

Using the checklist, you can start to build up a picture of where the various processes in your operating model are having an impact. Its then important to tackle these. It goes without saying that unless you fix the root cause, the fail will just happen again and again, so tackling systemic problems internally is crucial.

Action Plan

Here we give an overview of some of the activity that firms should be considering as part of their review of CSDR on their securities finance business.

SSIs – Review SSI sources and uses and crucially how these are maintained. There are challenges around agency lending and repo processes, where multiple SSIs are used by an agent to reflect the underlying fund settlement instructions. Booking practices along with processes to match and agree these with the counterpart will be vital.

Processes – Review manual processes, particularly around life-cycle events and build up a comprehensive picture of the controls and automation around these. Where possible, identify where the fail is caused by a process. New processes around fines management also need to be thought through and established, with clear responsibility for managing the passing on and collecting fine costs from clients and counterparts.

Timing - The timing of processes will be critical. Where there is a reliance on overnight processes these need to be moved to at least intra-day if not real-time.

Pre-matching, confirmation and affirmation processes – Review the use of these processes and build in both the results to your exception handling and your settlement instruction release processes. The more real-time these processes are the better.

Automation of life-cycle events – Many manual processes can be automated today, particularly pre-matching / reconciliation, return / off leg agreement and processing of mark to markets, along with SSI agreement and enrichment. In addition, processes such as releasing instructions can be linked to matching status, in order to automate these further.

Exception handling – Ensure exceptions can be easily identified and routed to the correct team or individual, with automated resolution where possible. An additional technology such as machine learning and robotics to aid with resolution in high volume processes, will also help manage the impacts of CSDR.

Custody review – Understanding the complexity of the firms custody network will be vital, and engagement with both global and local custodians in order to understand how they are planning to operate and how this will impact you is critical. Many securities finance businesses have their own custody network. These firms need to ensure the engagement of their network management teams to help manage and assess these relationships.

MIS – Establish MIS requirements early in your project planning, this will both help with root cause analysis, but also with management of processes going forward.

How Pirum can help?

Pirum provides real-time post trade services that help firms automate processes and minimise fails. We have a comprehensive suite of services, including indicative CSDR fails costs reporting. This helps firms assess the impact of the regime on their processes and provides workflow management to help identify and prioritise fails in order to prevent them in the first place.

Pirum helps

86%

Reduce breaks

99%

Increase STP rates

CSDR

Cost Visibility

Reduce costs

Contact us to find out how we can help minimise the impacts of CSDR

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Every day Pirum processes over 2million of transactions and $1.5tn of collateral, achieving over 99% STP for some of the biggest financial companies in the world.

Pirum offers a secure, centralised automation and connectivity hub for global securities finance (Stock Loan and Repo), cleared and uncleared derivatives and other bilateral transactions. We enable the complete automation of the post-trade and collateral lifecycle. Our position within the post-trade collateral landscape enables clients to seamlessly access counterparts, tri-party agents, trading venues, market data companies and CCPs, as well as regulatory reporting facilities.

We combine an in-depth understanding of both the collateral management industry and state-of-the-art technology to provide highly innovative, modular, and flexible solutions. Supporting established and emerging financial institutions, Pirum's pioneering approach consistently reduces operational risk while increasing processing efficiency and profitability.

Pirum's innovation and customer focus have resulted in widespread industry recognition and multiple awards. Pirum has been named Global Post-Trade Service Provider of the Year five years in a row at the International Securities Finance Awards and won the RegTech Insight Awards 2020 (Best solution for SFTR with IHS Markit).

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