Prevention or cure – a present day conundrum

Scott Brown, Director, Business Development at Pirum,
discusses the Settlement Discipline Regime section of the Central Securities Depositories Regulation and its implications for mandatory buy-ins.

The Central Securities Depositories Regulation (CSDR) has been called many things by industry bodies and practitioners alike, 'the zombie regulation', 'the final piece of the post-trade puzzle', but one thing it has not been called is 'simple'. Depending on where you sit within capital markets, your perspective on the regulation will be different.

We have seen phases 1&2 take effect without too much fanfare, but perhaps this is because many institutions are already familiar with the omnibus / segregated account structures from their clearing brokers and the mandatory clearing obligations that the market accepted in the early part of the previous decade.

Phase 2 required institutions to report internally settled trades at any of the authorised CSDs for CSDR, which ESMA (the European Securities and Markets Authority) have published (Articles 21 and 58 of Regulation (EU) No 909/2014 (CSDR)).

The area that has gathered the most attention and perhaps been the most debated, is Phase 3 – Settlement Discipline Regime (SDR). Within this article we will focus on the impact this will have to Securities Finance and what institutions can do to limit the impact ahead of February 2022. As Benjamin Franklin famously advised fire-threatened Philadelphians in 1736 that "An ounce of prevention is worth a pound of cure." In the context of SDR, I think he was right.

SDR focuses on measures to prevent settlement fails and incentivising timely settlement with cash fines and (potential) buy-ins. There is a strong argument relating to buy-ins for securities lending specifically around application and impact to cost and liquidity.

At many an industry forum throughout the last year, practitioners have been sharing their views on what SDR means for securities lending and many appear to have made peace with the fines for fails, but what remains unclear is whether mandatory buy-ins will be applicable and if so when and how.

It is our understanding that ISLA, ICMA, AFME and others are lobbying for mandatory buy-ins to be delayed due to so many unanswered questions. These range from; the general appropriateness of certain components, to practical scenarios such as, how a buy-in is applied when there is a failing market trade and a failing loan or return(s). Are both bought in? And, if so, how?

Securities Lending is a practice with strong foundations built on relationships and buy-ins are seldom initiated due to it being deemed poor practice.

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Staying on mandatory buy-ins for the moment, the regulation states that a CSDR buy-in is expected to apply to both legs of a Securities Finance Transaction (SFT), except where the maturity of the trades is within 30 days. The wording of the regulation suggests that it is expressly intended to execute a buy-in against the start leg of an SFT and that the buy-in process will mirror the process used for market fails. Whilst in principle this is clear, the points raised previously suggest that the application of this is far from straightforward.

Whilst the narrative on buy-ins continues to evolve, let's turn our attention to PREVENTION of fails and how institutions can improve their operating model.

CSDR is an opportunity to eliminate some of the inefficiencies and risks endemic in the post-trade operating model. As such CSDR is more than just an exercise in regulatory compliance but rather an open door for smart, cohesive industry best practice.

High settlement efficiency has many benefits, across operational efficiency, risk management and reducing the impact of Risk Weighted Assets. It is a measurable benefit to any banking institution.

Pirum has been at the forefront of the drive to add STP and low fail rates to the Securities Finance market for 20 years and recognises the value and importance of best practice. (Pirum - CSDR Whitepaper: *www.pirum.com/whitepaper-securities-finance-and-csdr-dont-fail-to-deal-with-fails*)

Within Pirum's Future**Tech** Initiative (FTI) we have focused our product development to further support institutions in meeting their goals of enhanced STP and lower fail rates.

Pirum has a suite of products that are key to our current area of focus, PREVENTION. Alongside our much-loved real-time services and life-cycle automation, we offer timely and efficient collateral processes to ensure instructions are released to market at the optimal time, and that both key economics and SSIs are matched prior to Intended Settlement Date (ISD).

Pirum's FTI has created tools such as **Trade Risk Manager** – that helps institutions to make rate changes and change key economics in real-time, again, to prevent fails on either the start or end leg of the transaction.

Several items come to mind when we look at PREVENTION.

- CSDR requires standardised settlement matching fields including transaction type.
- Standardised settlement matching tolerances
- Continuous real-tie matching: economics, SSI's, and confirmations
- Hold and release functionality.
- Partial settlement
- Adoption of electronic tools

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Pirum continues to work with clients to review their operating model and has (since Jan 2020) provided existing clients with an indicative fails report, to give institutions a view on how their BAU activity would look in a SDR environment.

Whilst the industry looks at buy-ins, it would make sense to begin or continue looking at the following:

- Can I partner with my vendor(s) to utilise more functionality to complement and improve my operating model?
- Do the services they offer create enhanced STP and reduce the risk of fails?
- Are there services available that reduce communication time for changes to a trade that will impact settlement?
- Do you have certain clients / brokers who tend to fail more than others?
- How often are you unmatched? How often are you the cause of the unmatched? How often do you amend your transaction after ISD?
- Review your settlement efficiency for potential weakness in process.
- Reviewing your client pool to identify which clients may not be delivering on time when securities are recalled.
- How efficient are your settlement processes to execute and deliver lending transactions late in the day, so a review of your custodian and market deadlines could be beneficial.

Pirum actively supports and participates in several trade association and industry body best practice groups and is committed to improving the securities finance industry. There is a real opportunity to influence the implementation of an important regulation, but time (as always) is of the essence.

There is a short way to go but much to be done to be ready for go-live in February 2021. ■