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Penalty spot: are buy-side firms hitting the SDR target?

David Veal, Senior Executive: Client Solutions, corfinancial, considers how buy-side firms have adapted to the Settlement Discipline Regime and the operational challenges that remain.

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Introduction

After several false starts and delays, the Settlement Discipline Regime finally went live in February 2022. In this white paper we consider the anecdotal thoughts and feedback we have received from market participants who have been working with the new processes and protocols since then. Has the SDR been a success and what are the main challenges firms still have to work through?

The Settlement Discipline Regime is a new obligation stemming from the European Commission's review of the Central Securities Depositories Regulation (CSDR), which came into force on 1 February 2022.

These additional regulatory processes supplement the existing CSDR protocols and focus on enhanced controls and governance around trade settlement. The Settlement Discipline Regime covers enhanced processes in the following three areas:

1. **Failed Trade Management** - trade processing enhancements and controls to proactively mitigate settlement failure, where possible
2. **Cash Penalty Fees Management** - processes, reconciliation and payment
3. **Mandatory Buy-ins** - for failing stock delivery (subject to conclusion of European Central Bank recommendations)

According to the Funds Europe / RBC Investor & Treasury Services survey of September 2022, 50% of buyside firms have already increased their investment in internal systems as a result of CSDR, while 21% of buyside firms have either begun to or increased their outsourcing of technology. To monitor compliance with the CSDR and avoid settlement failures clearly requires either significant additional manual support or better processes.

Failed Trade Management

On paper it might appear that trade settlement fails are relatively inconsequential occurrences. An ESMA (European Securities and Markets Authority) survey of 31 European jurisdictions found that between two per cent and four per cent of all bond trades failed between 2018-2020. Equity trade fails averaged between five per cent and ten per cent during the same period. While 2021 data showed similar trends, ESMA noted equity settlement fails reached twelve per cent on three occasions between November 2020 and June 2021.

These relatively low fail rates imply that the settlement process is very efficient. The costs related to trade fails, however, is very high. In a market where billions of dollars of transactions are being settled each day, a percentage point translates into a large proportion of overall trades. And the above figures are still below the pandemic highs when fails climbed to around 14% for equities and close to 6% for government and corporate bonds.

Trade settlement failures occur for a variety of reasons. The most common problem is inventory management - when the securities are not where they're needed on the settlement date. Fails can also be caused by inaccurate or incomplete data sets, leading to matching issues.

According to the Funds Europe / RBC Investor & Treasury Services survey of September 2022, most settlement fails are a result of 'economic mismatches' (in other words, price or quantity of stock). This accounts for 27% of trade fails among buyside firms. Research by ESMA similarly reports that most settlement fails are related to operational challenges for market participants in delivering securities rather than a lack of cash.

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Buy-side firms in Europe that are trading with US instruments will have a reduced window in which to allocate and fund stocks, resolve any settlement issues and comply with the CSDR's new penalties regime.

If firms are to avoid costly settlement fails, they must improve the visibility and transparency they have into the securities transaction lifecycle. Having access to a central source of data and being able to track transactions throughout the entire securities lifecycle will be vital to facilitating settlement efficiencies.

To a reasonable extent, the clients we talked to felt they had robust governance in place with which to minimise trade settlement failure that could be associated with any errors in their automated process.

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Cash Penalty Fees Management

From our conversations it seems that the provision of prime broker or custodian statements to support the reconciliation of cash penalty fees is improving, but there is still a way to go. Early in August, it was suggested that some custodians were only reconciled to the end of May, but the backlog at some of the major firms is being addressed.

The sentiment we received was that some parties still lack the full infrastructure to manage penalties and do all the required back testing, so some may be choosing to absorb cash penalty fee debits rather than passing them on (although penalty fee credits are being sent). The argument is that penalty fee amounts are just too small, and net/net are not worth passing on.

In many ways it could be argued that this view fails to comply with the spirit of the SDR regulation, which is designed to improve governance, controls and monitoring of parties that do not perform as well as others. Passing on credits and absorbing debits can create a false reality of the performance of all parties.

When reconciling potential or real fails, one firm we spoke to said that they must investigate around 700 debits and credits a month. Clearly this is very time consuming and compounds the operational burden, as their internal process means they must investigate every trade.

There has been industry talk of writing off cash penalties below EUR50, although there are arguments to make this EUR25 so that the asset managers are still able to assess the performance of parties they engage with.

From our conversations we have ascertained that approximately 50% of penalty fees are under EUR25 but some firms have seen fees in the region of EUR3,500 due to counterparty errors.

Mandatory Buy-Ins

In June 2022, The European Securities and Markets Authority (ESMA), the EU's securities markets regulator, published a Final Report on amending the regulatory technical standards (RTS) on settlement discipline to postpone the application of the CSDR mandatory buy-in regime for three years.

The proposed amendment is based on the expected changes to the CSDR buy-in regime presented in the European Commission's proposal for the CSDR Review and on the amendment made to CSDR which allows ESMA to propose a later start date for the CSDR buy-in regime.

In October, the European Parliament published a report in which it is proposing to dispense with mandatory buy-ins altogether. This follows similar recommendations from the European Commission. If this were to be approved, the industry would have one less settlement-related headache to worry about as it continues to battle with issues around CSDR penalties and fail rates throughout the continent.

Automating The Processes

After many months of testing various CSDR solutions, one of our clients found that the data content provided was insufficient to meet their operational needs. The key problem was that it was based on the custodian or prime brokers' view of transactions. It seems that the data presented by third parties was incomplete, late or inaccurate, potentially because it is formed of data extracts that are not a comprehensive record of the client's view of their active trade lifecycle. It is estimated that data has been approximately 75% accurate when matched against the local record, although this differs from day to day.

Taking a counterparty's collated view of transactions could be perceived to be cost effective rather than intra-day SWIFT messages from global custodians at transaction level, but it doesn't meet the near real-time data provisioning that the market is anticipating. Using the brokers' view of trades may be equally flawed as it relies on all brokers positioning their side of a trade quickly and accurately (a moving target that is not likely to change in the foreseeable future).

The SureVu SDR solution from corfinancial was designed differently.

SureVu clients believe it is essential to manage post execution trade settlement positions from their own record of executed trades.

SureVu is based on an asset manager's view of all security trade records, post-execution, and uses this as the foundational record of trades to be managed.

With SureVu, SWIFT messages are received from custodians and prime brokers that can support this communication protocol on an intra-day basis to reflect the settlement status of trades before settlement date, and thence until market settlement occurs.

Simply put, local trade records must form the basis of failed trade management.

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Join other **high performing** buy-side firms managing CSDR Settlement Discipline Regime operations with confidence and ease

A system built for the buy-side providing proactive trade monitoring and full SDR compliance

Do you want a modern approach to Operational challenges?

Do you really know where you are using a third-party's view of 'your' executed trades?

Do you really have time to waste managing cash penalties fees?

"It's not about managing failed trades. It's about knowing when they are ready to settle."

Tier One Hedge Fund Manager and SureVu Client

Be **Confident**
Be in **Control**
Govern with **Ease**

Click here to learn more about corfinancial's SureVu solution

Why Is The SureVu Way Different?

Rather than running middle office processes that focus on managing failed trades, some firms want to change their operational stance so that they monitor trade positions that are complete and pre-matched - being likely to settle unless a broker is short on stock. With this failure mitigation approach occurring much earlier in the trade lifecycle, firms are better placed to mitigate cash penalty fees and more importantly have an accurate method of managing the effectiveness of counterparties.

The introduction of SDR was based on a principle of improvement in the standards among the parties involved in the trade lifecycle process. If records are not accurately reflected and managed in every instance, and if cash penalties are absorbed or written off, it would seem that the principles behind the regulation are in danger of being diluted in favour of a simpler but limited process of data management as a whole.

As it seems that the automation of buy-ins is very much in doubt, the incentive to 'get things right' is waning, leaving buy-side firms to decide whether good controls, processes and a constant evaluation of counterparties is the best practice they want to employ.

If this is the future for the industry, then SureVu is the perfect solution as it removes dependencies on position data derived from a third party.

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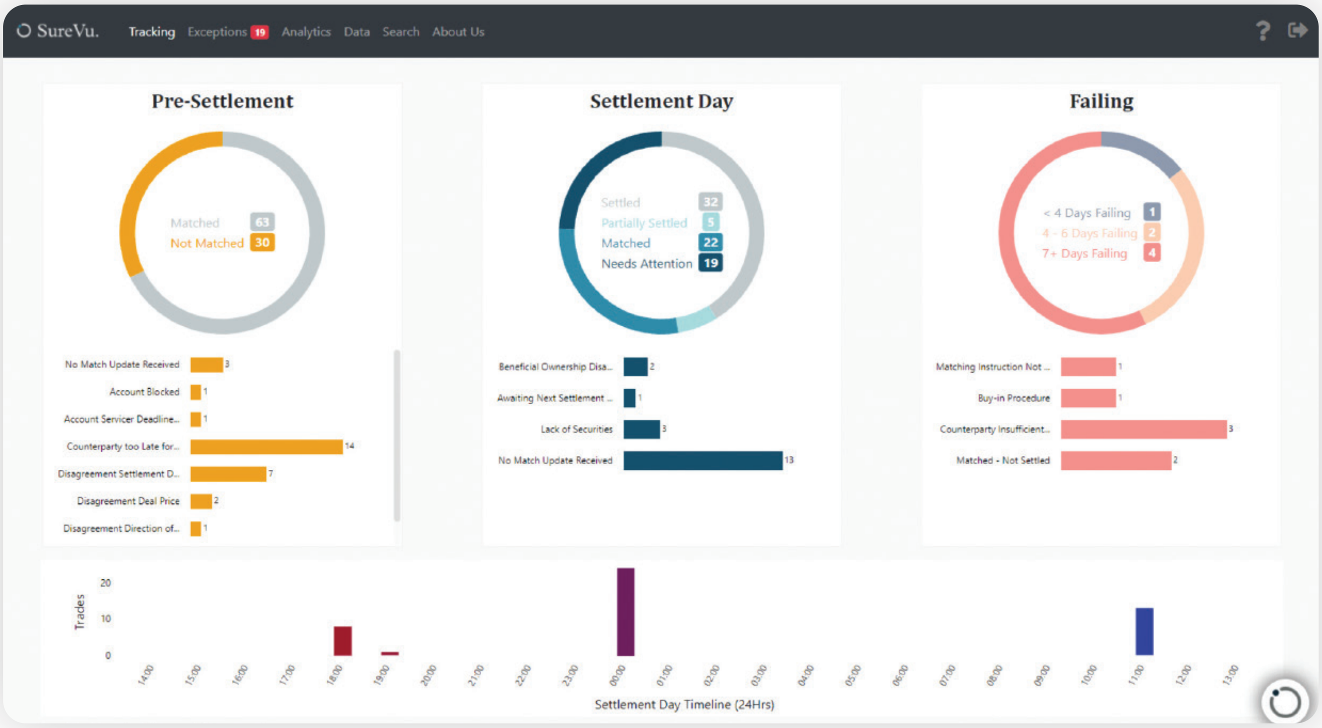
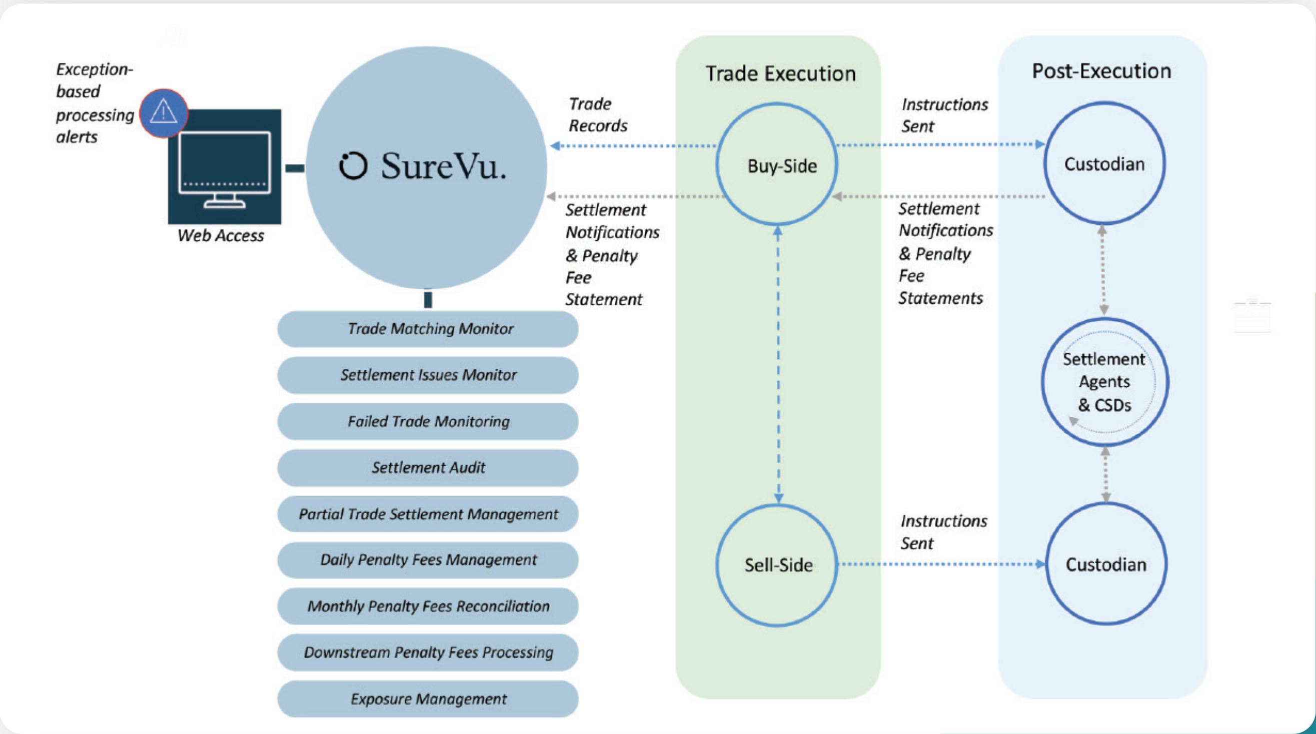
The SureVu Dashboard



The SureVu Process



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SDR And T+1

Settlement has been a major issue over the past 24 months within Europe, with fail rates notably high and the SDR regulation landing – enforcing reporting requirements and penalties on market participants for failed trades.

More industry regulation in this space will also affect the impacts of SDR. Many believe that T+1 in the US will be shortly followed by T+1 in Europe and thence on a more global basis. The implication of this is that changes in practices are needed now. If adopted as a concrete set of rules, T+1 settlement would come into effect in the US as early as 31 March 2024.

Yet the barriers to timely settlement in the current model need to be fully understood and addressed before Europe can move to T+1. A rushed or uncoordinated approach is likely to result in increased risks, costs and inefficiencies, particularly given the unique nature of European markets which have multiple different market infrastructures and legal frameworks.

Given these ongoing issues and the previous pan-European settlement system rollout taking up the best part of a decade, experts have often aired frustration when prompted to discuss the notion of now reducing settlement times on the continent.

Conclusion

As buy-side firms, their prime brokers and custodians begin to see the reality of the Settlement Discipline Regime in operation, some are looking to obfuscate the problems they encounter while others see an opportunity to step ahead of their competition with effective governance. For firms that see the value of enhanced controls, data management and processes that help them police the parties that support them, SureVu is a solution that meets this mindset.

Some buy-side firms seek to enhance their controls and governance, not dilute them. SureVu requires prime brokers and custodians to use structured data and industry standard codes, which leads to improved data governance.

Our clients want to run metrics on their counterparties to ensure they book trades on time, and to have data measuring bad performers. They also think that the only way forward is a middle office process that is fully focused on failure mitigation, not failed trade management.

The overall sentiment is that buy-side firms should be preventing fails, not managing them. In this way it is essential to manage all pending trades, not just failed ones. By better managing unsettled trades, some of our clients have already seen a 25% improvement in settlement rates and they intend to improve this further with SureVu. The message is that it is absolutely essential to meet stricter settlement processing times now as part of the global shift to T+1 .

Solely looking at fails or counterparties' data is no longer sufficient. Controlling 100% of trades pre-settlement is the only effective way forward.

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Click here to learn more about corfinancial's SDR solution, SureVu.

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Visit: www.corfinancialgroup.com

ABOUT CORFINANCIAL

corfinancial provides software solutions and advisory services to banking and financial services organisations worldwide. The firm has offices in London, New York, and Boston.

There are five key problem areas corfinancial looks to solve through its primary software and service offerings:

BITA Risk provides Investor Profiling, Portfolio Analytics, ESG Management and Portfolio Monitoring solutions to wealth managers through the BITA Wealth application. Available as individual modules or as an end-to-end solution.

SureVu empowers buy- and sell-side firms to efficiently monitor and track security trades throughout the settlement lifecycle, enabling users to proactively manage and oversee settlement exposure.

salerio is a post-trade processing solution that enables asset managers, hedge fund managers and securities/fund services firms to automate the flow of securities and treasury trades from matching through settlement.

costars is an investment administration platform for third party administrators, fund supermarkets and wealth management companies.

paragon is a comprehensive front-to-back office fixed income portfolio accounting, processing, and reporting solution for banks.

other solutions from

corfinancial.
london | boston | new york

paragon.

Fixed-income accounting hub delivers front to back-office portfolio accounting and processing solutions.

bitarisk.

End to end private client suitability, ESG, risk and portfolio management with enterprise monitoring and oversight.

salerio.

Automates the flow of securities and treasury trades from matching through to settlement.

costars.

Retail fund/transfer agency solution providing end-to-end administration for collective investments.