



# TMPG | Treasury Market Practices Group

## Announcement

### Treasury Market Practices Group Endorses Several Measures to Address Widespread Settlement Fails

November 12, 2008

Recent market turbulence and unusually low short-term interest rates have resulted in a substantial increase in widespread and persistent settlement fails in U.S. Treasury securities. While some settlement fails are inevitable, these widespread and persistent fails prevent efficient market clearing and impose credit risk on market participants, and are therefore damaging to overall market liquidity.

The Treasury Market Practices Group (TMPG) is committed to restoring efficient functioning of the U.S. Treasury market. The TMPG is recommending the following changes in market practices and will be engaged in the follow-up efforts described below in order to remediate the prevalence of widespread and persistent fails and to prevent their recurrence.

1. Financial penalty on fails: Past experience – for example during the summer of 2003 – shows that settlement fails in a particular CUSIP may become widespread and persistent when the special collateral repo rate for that CUSIP nears zero. Special collateral repo rates cannot exceed the Treasury general collateral repo rate. As a result, settlement fails across a variety of CUSIPS can similarly become widespread and persistent when the Treasury general collateral repo rate is near zero – as is currently the case.

The underlying problem is the Treasury market contracting convention that a seller can deliver securities after the originally scheduled settlement date at an unchanged invoice price, i.e., without incurring any penalty. Introduction of a dynamic fails penalty with a finite cap rate would remedy this problem. In particular, a dynamic fails penalty would provide an incentive for sellers to resolve fails promptly, and

could lead to repo contracting conventions that would give beneficial owners of Treasury securities an opportunity to earn as much as the cap rate in securities loan fee income regardless of the level of nominal interest rates.

The TMPG recommends that market participants agree that the invoice price--that is, the cash amount that a buyer has agreed to pay against the delivery of securities--on any cash or financing transaction that fails to settle on the originally scheduled date be reduced at a fails penalty rate equal to the greater of (a) 3 percent per annum minus the fed funds target rate at 5 p.m. EST on the business day prior to the originally scheduled settlement date, and (b) zero.

Recommended Fails Penalty Rate Formula:  $\text{Max}(3 \text{ percent} - \text{fed funds target rate}, 0)$  When the fed funds target rate is greater than or equal to 3 percent, there would be no explicit financial penalty for failing, and under this formulation the penalty rate would be capped at 3 percent per annum.

This out-of-pocket cost to the party failing to deliver securities will provide a compelling incentive to resolve fails promptly. If a failing counterparty is unable to find a security to make delivery, it will be motivated to pursue voluntary settlement options, such as bilateral cash settlement or borrowing collateral at negative repo rates.

The TMPG recognizes that the introduction of this new convention--a financial penalty on the originally scheduled settlement date, as described above-- raises operational, legal and other implementation issues that may vary across various Treasury market participants. The TMPG will engage in further analysis of these issues and expects to make recommendations for implementing the new convention by January 5, 2009.

2. Margining of settlement fails: When sellers fail to deliver securities in settlement of agreed upon trades, counterparty risk exposures grow and can become acute as these fails age. To mitigate counterparty risk and to better incentivize delivery by increasing the cost of aged fails, the TMPG recommends that market participants take prompt steps to study the most efficient way to commence margining of fails in all cash and financing transactions in Treasury securities. The TMPG plans to convene a working group on this subject to make a recommendation by January 5, 2009.

3. Bilateral cash settlement: The TMPG recommends that market

participants immediately pursue mutually agreed, bilateral cash settlement of failing Treasury transactions for fails aged 5 days or longer. The TMPG urges counterparties not to allow narrow disputes over valuations to inhibit timely cash settlement, and expects that counterparties will work together in good faith to cash-settle trades at commercially reasonable prices.

4. Support development of broader multilateral netting solutions: The TMPG will look to the Fixed Income Clearing Corporation, major clearing banks, and other interested parties to develop new or enhanced standing multilateral netting arrangements that reduce the number and severity of fails and, at the same time, address reasonable confidentiality concerns of market participants. Such tools can be used to significantly reduce settlement fail chains when aggregate settlement fails build or become chronic. Separately, the TMPG will explore with the market the feasibility of publishing specific issue fails data to improve market transparency.

5. Backstop standing Treasury facility: The TMPG supports discussion of a standing facility by the U.S. Department of the Treasury to provide temporary new supply of specific securities at a penalty rate when settlement fails persist, as a long-term goal. The TMPG understands that the creation of such a facility is not possible in a short timeframe. Progress by the private sector on the preceding initiatives should not be dependent on the development of a backstop standing Treasury facility.