TMPG | Treasury Market Practices Group

Claiming a Fails Charge for a Settlement Fail: Frequently Asked Questions
The following is intended to address questions about the Treasury Market Practice Group's (TMPG) recommendation that a charge for settlement fails in U.S. Treasury securities at very low nominal interest rates be adopted as standard market practice. *Please refer to the Fails Charge Trading Practice for further detail.*[1]

Revised March 31, 2009

General

Why is the TMPG recommending a financial charge on settlement fails?
During the past several months, transactions in U.S. Treasury securities have exhibited widespread and chronic settlement fails. These fails prevent efficient market clearing and impose credit risk on market participants, and are therefore damaging to overall market liquidity and function. The imposition of a fails charge would increase the incentive for sellers to effect timely settlement and, it is expected, mitigate the fails problem that has been affecting the market.

Does the fails charge apply to cash and financing transactions?
A fails charge could arise from a conventional cash market sale or from a repurchase agreement or securities loan, including the borrowing of funds on the start leg of a financing transaction and the return of funds at the conclusion of a financing transaction. In short, a fails charge is recommended for all delivery-versus-payment settlement obligations in the U.S. Treasury market, regardless of the source of that settlement obligation.

Who is considered a "buyer" and a "seller"?
A seller is any party who has agreed to deliver Treasury securities, or who has agreed to cause Treasury securities to be delivered, versus the payment of funds. A buyer is any party who has agreed to make payment of funds, or to cause payment to be made, upon receipt of Treasury securities.

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[1] The "U.S. Treasury Securities Fails Charge Trading Practice", published by the TMPG and the Securities Industry and Financial Markets Association (SIFMA), is available at http://www.sifma.org/capital_markets/docs/fails-charge-trading-practice.pdf

Does the fails charge apply to transactions where payment of funds is not required upon receipt of Treasury securities?
No, the TMPG recommendation does not cover "free deliveries", where a recipient is not obliged to make a payment of funds upon receipt of Treasury securities. Free deliveries can arise when, for example, an investor has to make a deposit of securities for margin purposes.

How does the TMPG recommendation apply to any market participant in the Treasury market?
Although the TMPG strongly recommends the adoption of the fails charge practice recommendation, the TMPG's market practice recommendations are voluntary.

Why is the TMPG recommending an interest claim approach as opposed to a change in the invoice price?
The TMPG's original November 12, 2008 recommendation suggested that the invoice price of a transaction that failed to settle as originally scheduled should be reduced by the amount of the fails charge, but when market participants studied the recommendation further a consensus emerged that a monthly claims process is preferable to adjusting invoice prices because it presents a much lower operational burden than invoice price adjustment.

When will the recommended fails charge take effect?
The TMPG recommends that transactions entered into on or after May 1, 2009 be subject to the fails charge. Given this target implementation date, the first submission of claims for fails charges relating to delivery failures settled or resolved during May 2009 would be June 12, 2009. For fails settled or resolved in June 2009 fails charge claims would be submitted by July 14, 2009 (which is the tenth business day of July).

These planned implementation procedures were formulated after consultation with a variety of market participants and reflect the desire to balance the operational, legal and other implementation challenges faced in adopting this new practice, with the need to expeditiously remedy the prevalence of widespread and persistent settlement fails. The implementation of the fails charge pursuant to this timeline will be subject to the Securities and Exchange Commission's (SEC) approval of a rule filing by the Fixed Income Clearing Corporation (FICC) regarding the application of the fails charge to its members. [2]

Will the TMPG's recommended fails charge improve Treasury repo and cash market liquidity?
We expect the implementation of this market practice will reduce the likelihood and incidence of widespread settlement fails in the Treasury market, and this in turn will support deeper cash and repo market liquidity.

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[2] [2] The applicable rule filing SR-FICC-2009-03 is available on the FICC's website at http://www.dtcc.com/legal/rule_filings/ficc/2009.php

Won't a fails charge and the new framework under the TMPG's recommendation just serve as an incentive for bad behavior by repo desks and repo "games"?

The existing TMPG best practice guidance advocates strongly against such practices and TMPG practice guidance can be updated if new issues arise. Engaging in manipulative or fraudulent activity may subject a firm to regulatory enforcement action under applicable laws. Official scrutiny is nothing new for the Treasury market, and the TMPG believes it would be imprudent for traders to look for small profits that increase franchise risk to the entire firm. The TMPG believes that improper behavior is not riskless for its practitioners in the Treasury market.

Will the imposition of a fails charge encourage large holders of securities to lend even in the event of a sharp increase in credit concerns?

Not necessarily, and the fails charge is not expected to eliminate all fails. The TMPG recommendation merely seeks to mimic the incentives for prompt settlement that exist when the Treasury general collateral (GC) repo rate is around 3 percent. Market dislocations following the September 11 attacks show that securities lenders can pull back for credit reasons even when the Treasury GC repo rate is higher.

Does the official community support the TMPG's recent recommendations?

Yes, both the Federal Reserve Bank of New York and the U.S. Department of the Treasury have announced support for the TMPG's recent initiatives. On November 12, 2008 the New York Fed endorsed the TMPG's recommendations to address widespread settlement fails, and on January 15, 2009, endorsed the Fails Charge Trading Practice. In addition, on January 6, 2009, the U.S. Treasury Department released a statement in support of private-sector initiatives, such as the measures announced by the TMPG, to further enhance the depth and liquidity of the U.S. Treasury market.

How will fails charges be treated for tax purposes? For example, will they be treated as capital gains or losses, interest income, or an offsetting fee on regular custodial fees?

Accounting and tax related implications of this new practice undoubtedly vary across firms and institutions and the TMPG advises each participant to consult with their own accountants and tax advisors on these important matters.

Does the TMPG fails charge recommendation apply to settlement failures in Agency debt?

No, the fails charge recommendation applies only to U.S. Treasury securities at this time. The U.S. Treasury market consistently has large structural short positions due to hedging and market making activities. Such activity is less substantial in Agency debt markets and aggregate settlement fails are correspondingly of much lower magnitude. At the same time, the TMPG recognizes that successful implementation of these trading practice recommendations in the Treasury market may lead to their adoption in other debt markets in the future.

Fails Charge Calculation

What is the recommended rate charged on fails?
It is recommended that a settlement fails charge be calculated each day based on the greater of (a) 3 percent per annum minus the TMPG reference rate* at 5:00 p.m. New York time on the preceding business day, and (b) zero. When the TMPG reference rate is greater than or equal to 3 percent under the current formula, there will be no explicit financial charge for failing, and under this formulation the fails charge will be capped at 3 percent per annum.

* Note: The current TMPG reference rate is the target federal funds rate specified by the Federal Open Market Committee (FOMC) (if the Committee specifies a target rate) or the lower limit of the target band specified by the FOMC (if the Committee specifies a target band in lieu of a target rate). In the event the FOMC specifies neither a target rate nor a target band, the TMPG will recommend some other similar, readily observable, short-term interest rate.

How is the recommended fails-related payment calculated?
The amount charged for a failure to receive securities on a given day will be computed according to the following formula:

$$C = \frac{1}{360} * .01 * \max(3 - R,\ 0) * P$$

where:

C = fails charge amount, in dollars

R = TMPG reference rate at 5:00 p.m. New York time on the preceding business day, in percent per annum, and

P = total trade proceeds due from buyer, in dollars

Why is the recommended fails charge formula based upon a 3 percent rate level?
The TMPG recommendation is designed to give sellers an economic incentive to borrow securities to affect deliveries even when the general collateral repo rate, which is usually very close to the fed funds target rate, is low. Experience shows that fails have rarely become widespread and chronic if the general collateral rate is above about 3 percent. This suggests that market participants generally act to cure settlement fails reasonably promptly as long as the economic cost of a fail is not less than about 3 percent. It is possible that a future practice recommendation would suggest a rate higher or lower than 3 percent if future market dynamics differ materially from the historical experience.

What happens if there is a change in rates in the middle of the month?
It is recommended that fails charges be calculated each day, based on the TMPG reference rate on the preceding business day. Therefore, if there is a change in the TMPG reference rate in the middle of the term of a delivery failure, the rate will be that new rate

for subsequent days of the fail (assuming that the TMPG reference rate does not again change during the remaining term of the delivery failure).

If the TMPG were to recommend that a different rate be charged on fails, what would be the lead time for such a decision and how would that be communicated?
In the event this were necessary, the TMPG would discuss the appropriate timeline for implementation for such a change with a wide range of market participants to assure that the change would not be disruptive to market function.

Can you provide an example of the charge for a failure to deliver? In addition, how will a claim be calculated if a fail extends for a time over more than one month.
Assume that a buyer purchases a 2-year Treasury note for settlement on Thursday, October 29, 2009, and that the price plus accrued interest equals $100,000,000. Also assume that the seller does not deliver the securities to the buyer until Tuesday, November 3, 2009. The seller would be charged based on a settlement failure for five days. Under this scenario, the buyer would have the ability to submit a claim for a fails charge cumulated over five days—Thursday, October 29 through Monday, November 2—by the 10th business day of December, and the seller would then pay or reject the claim by the last business day of December.

Based on the example in the previous question, and the TMPG's recommended fails charge formula, what would be the claim amount?
The preceding example provides all the necessary information, except for the rate used to calculate the fails charges on each day. For simplicity's sake, let's assume that the TMPG reference rate for the duration of the fail is 1 percent. The fails charge for each of the five days would be calculated as:

$$C = \frac{1}{360} * .01 * \max(3-1,\ 0) * \$100{,}000{,}000$$

$$C = \frac{1}{360} * .01 * 2 * \$100{,}000{,}000$$

$$C = \$5{,}555.56$$

Therefore, the claim amount would be the sum of these charges over the five days, or $27,777.78.

Why is the TMPG recommending that fails charges be paid after a transaction settles, rather than on a monthly accrual basis over the life of a fail?
This aspect of the TMPG's fails charge recommendation results from the finding that most asset manager and custodian systems are based on trade settlement and that paying fails charges on a monthly accrual cycle would be overly burdensome to implement because the existing systems could not be used for tracking and reconciliation. This finding is based upon guidance from a SIFMA working group comprised of the largest buy-side and custodian participants in the Treasury market.

Fails Charge Claim Submission and Payment

What contracts does my firm need to sign in order to submit or be owed a claim?
The TMPG and the Securities Industry and Financial Markets Association (SIFMA) have published a suggested framework of legal documents and market conventions through which a fails charge may be imposed and collected. This framework includes (1) a Trading Practice providing greater and more precise detail regarding the fails charge, (2) recommended language, referring to the Trading Practice, to be included in transaction confirmations and (3) a recommended form of notice, to be sent by dealers to counterparts, that transactions will be conducted in accordance with the Trading Practice. These documents have been published and will be maintained by SIFMA on its website.

How often will fails charge claims be assessed?
The TMPG recommends that fails charges be accrued over the life of a delivery failure, but that claims for such charges are issued monthly, only after the delivery failure is resolved. In other words, a delivery failure spanning more than one calendar month would result in a single claim, based upon the fails charge over the entire duration of the fail, in the month following the month in which the delivery failure is resolved.

When will the claim be due to the counterparty and when does the claim have to be paid?
It is recommended that claims for all fails charges accrued over the life of a fail be issued by the tenth business day of the month following the month in which the delivery failure is resolved, and either paid or rejected by the last business day of the month in which they were submitted.

To whom does my firm send the claim?
The recipient of a claim will differ depending on the counterparty. Please see the document titled *"Claiming a Fails Charge for a Settlement Fail in U.S. Treasury Securities"* for further discussion of several payment flow scenarios.[3]

Is there any minimum threshold for fails charges?
The Fails Charge Trading Practice currently contains an exemption for accrued fails charges of less than or equal to $500, on a per trade basis.[4] Although the TMPG believes that the ideal threshold for fails charges is zero for all market participants, the TMPG anticipates that adoption of this minimum threshold will facilitate widespread adoption of the Fails Charge Trading Practice. The TMPG may revisit this threshold recommendation should an industry utility emerge, or if the threshold leads to unexpectedly large asymmetries or materially undermines the pass-through of the fails

[3] These payment flow examples and this document in general are meant to be illustrative and supportive of gaining a better understanding of the economic rationale that motivated the fails charge, they are not meant to be a complete collection of all possible applications of this new market practice.
[4] Based on allocated trade amounts, that is, if a $30 million trade is broken down into $10 million and $20 million tickets, then the relevant trade sizes become $10 and $20 million. This allocation must be known by both counterparts before the original settlement date.

charge. It is expected that the FICC will have no minimum threshold due to the nature of FICC netting and novation.

If a seller attempts to make a partial delivery of Treasury securities to a buyer and the buyer rejects the partial delivery, does the buyer have the ability to submit a claim for a fails charge on the full amount of securities underlying the transaction?
A buyer is entitled to receive from the seller the full amount of Treasury securities underlying a transaction. As such, a buyer who fails to receive the full amount of Treasuries on the originally scheduled settlement date of a transaction would be entitled to submit a claim for a fails charge on the full amount of securities, notwithstanding the attempt by the seller to make a partial delivery. The economic consequence of this practice is no different that the economic consequence of rejection of a partial delivery under higher nominal interest rate regimes, where the recommended fails charge would not apply.

If a seller of a security is being claimed for a failure to deliver, and the reason for failure is that the seller is failing to receive securities on either a purchase, reverse repo or maturing repo transaction, will it be possible for the seller to assign the buyer's claim and in effect step out of the claim process?
It eventually may be possible to do this in the context of an industry utility, when the claims and *ex ante* acceptances could be netted across different parties. However, initially, in what is essentially a bilateral system, the TMPG believes that assignments of fails charges will only lead to prolonged deferrals of payments and increased implementation costs. .

What happens if claims are not paid on time? Are there any guidelines for how to handle disputed claims?
In the immediate future, claims disputes are expected to be handled bilaterally and the TMPG expects that counterparties will discuss the resolution of disputes in good faith.

Has any thought been given to the Federal Reserve effecting payment or receipt of the fail charges much the same way it effects payment or receipt on mortgage backed securities' (MBS) principal and interest via interim accounting rules and fails?
Fedwire Securities does not provide trade matching and MBS fails are not identified until settlement. Fedwire Securities' fails tracking service simply facilitates claims adjustments for principal and interest payments for transactions that settle between record date and payment date. Principal and interest is paid to the holder as of record date and a subsequent claims adjustment is processed. The fails tracking does not contain the calculation functionality required to compute recommended fails charges for Treasury securities.

When will I learn more about the industry utility referred to in the document titled *"Claiming a Fails Charge for a Settlement Fail in U.S. Treasury Securities"*?

The TMPG will engage in further consultation with market participants and industry representatives to explore the development of an industry utility for matching fails charge claims with *ex ante* acceptances submitted by market participants. The TMPG will continue to provide updates on progress toward this goal on an ongoing basis.