

Handling failed trades: A case for standardization

Banking, Financial Services and Insurance



Abstract

With every upheaval in an industry comes a regulation, which becomes a baseline or guiding principle to avoid any such instances in the future. The Central Securities Depository Regulation (CSDR) was introduced by the European Settlements and Markets Authority (ESMA) in 2014 to ensure that transactions between buyers and sellers of securities are settled in a timely and secure manner.

The main purpose of the regulation is to make market operations more resilient and efficient by introducing harmonious and unanimous securities settlement standards across Europe. CSDR also suggests strengthening and protecting the Central Securities Depositories (CSDs) by providing them the guidelines to operate efficiently. With these regulations in place, there is a dire need for certain evolutionary actions or trends, including standardization and harmonization of the post-trade process. One of the effective solutions that accomplish these requirements is setting up a buy-in agent or system for failed trades. This white paper explores how a buy-in agent or system will address the standardization of post-trade processes and ensure a uniform handling of failed trades.

Understanding failed trade or settlement

A failed trade – also known as unsettled trade – occurs when a seller fails to deliver security or the buyer fails to pay for the bought securities. In both cases, the parties fail to fulfill their obligations before the settlement due date. A failed trade later triggers various financial risks down the ecosystem, causing a cascading chain of impacts. For instance, the party which has not obliged has to bear financial losses, penalties, counterpart relation, and credit risk downgrade. Failed trade happens due to reasons including – but not limited to – issues with funding, short of security, inefficient manual process, or a glitch in the automated process.

The European Settlements and Markets Authority (ESMA) introduced the Central Securities Depository Regulation (CSDR), and this will impact investment banks, asset managers, brokers, dealers, custodians, funds, and Central Securities Depositories (CSDs). The CSDR has set out measures to prevent and address failed settlements and encourage settlement discipline. These include monitoring failed settlements, collecting and distributing cash penalties, and specifying the operational details of the buy-in process.

A solution to avert such risks could be any product or tool that enables clients to fulfill their obligation and complete the loop of the failed trade. This solution must be least prone to market risks and have better liquidity management and consistent securities settlement capabilities.

Buy-in requirement details

CSDR describes the requirement of a buy-in agent in two ways: preventing failed trades and addressing failed trades. The way we see it is that the value chain should be robust enough to showcase allocation-settlement durations, two-way communication for settlement confirmations and messaging, calculation, and settlement of cash penalties in an unbiased manner.

An ideal solution must include several modules like master-client data, reference data, price data, core and auction, collateral or pledge, settlement, reporting, and operations. Further, there should be a communication channel and reporting utility for all stakeholders involved, and the solution should be accessible through various platforms like web, mobile, and APIs.

Understanding the ideal solution

In the event of a failed delivery from the original seller – called a failing counterparty (FCP) – the buy-in solution (see Figure 1) should enable clients with a means to purchase a substitute of securities from a third party through a transparent auction mechanism. The FCP must reimburse all costs associated with the auction process, including the difference between the original purchase price and the buy-in derived price, as well as fees for the buy-in transaction. In case of an unsuccessful buy-in, compensation becomes a mandatory procedure for all failed transactions.

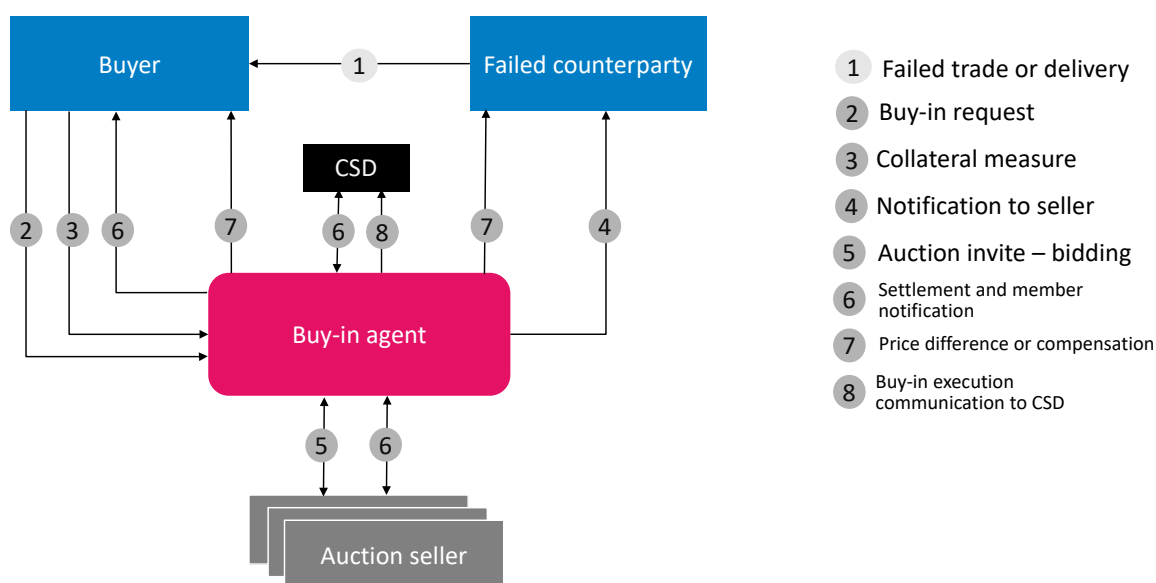


Figure 1: The basics of an ideal buy-in solution

Case-in-point

To understand the solution better, let us take the example of a large exchange and clearing house. In an effort to adhere to CSDR's new regulatory framework and thereby improve its settlement discipline, the clearing house wanted to employ a neutral third party to act as the medium. A development plan for the buy-in solution was designed following the single responsibility principle, an event-driven architecture, and a layered pattern. Backed by cloud, automation, and agile best practices, the buy-in solution (see Figure 2) was built, enabling the clearing house to initiate requests for seeking missed securities and fulfill their regulatory obligations.

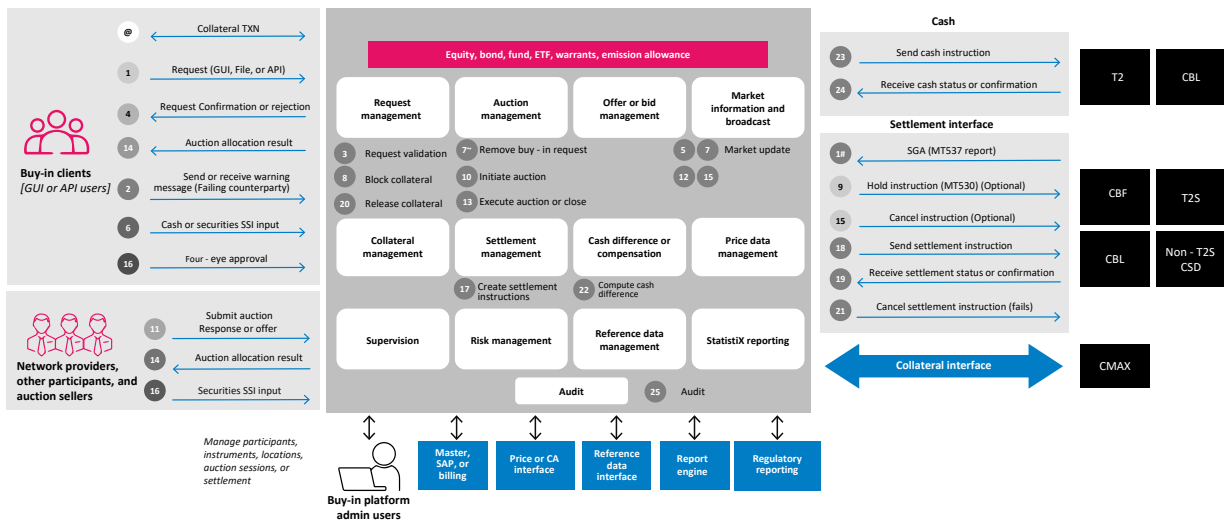


Figure 2: A high-level functional overview of the buy-in solution

Some of the functional modules that an ideal buy-in solution must have are:

Comprehensive data management

The solution must handle static data at the legal entity, user, and access right levels, portfolio, and SSIs. The data management must also provide master data details related to the application like holidays, currency, CSD, cash location, intermediaries, and other buy-in parameters.

All-rounded integration

To fetch the reference data of an instrument for business validation, the buy-in solution must connect with external systems. In addition, it must be integrated with price interfaces to fetch historical, intraday, and EOD prices, which are required for the calculation of bidding and offer price, price difference, compensation calculation, and other settlement purposes.

Compliance validation

The tool must be programmed to accept requests entered by business users and validate them as recommended or mandatory for the purpose of compliance, risk, collateral, settlement, and auction.

Collateral calculation and lien

Upon receiving margin and haircut parameters from other interfaces, the application must perform the collateral calculation. Collateral becomes a lien for the investment bank and serves the purpose of mitigating the liquidity and default risk for the buy-in system.

Support for auction or bidding

Based on pre-defined rules for matching prices and quantities, the solution must be equipped to execute the auction. This will be core for the application, as it ensures the whole process is fair and unbiased for all the stakeholders.

Settlement instruction and response

Post the auction, the trade is created, and the buy-in solution must send the settlement instructions to CSD. If any member has provided power of attorney, the solution will send instructions on their behalf; otherwise, it must generate settlement notifications for members so that they can use it and execute the instructions themselves. The structure of instruction that is sent to the settlement organization should ensure all instructions are settled on the same day, thereby eliminating delays in the process.

Compensation calculation

Algorithms for calculating the difference or compensation of price to be settled between the clearing house and failing counterparty must be developed.

Communication

Admins and operations teams must be given the facility to contact or pass information amongst the team and between other teams.

Reporting

The solution must comprise dashboards with reporting abilities, which allow business users to download the data in various formats.

Audit

One of the most crucial attributes for the solution is enabling operations teams to audit the actions performed through various routes like GUI or API.

Further, the core architecture of the application is such that it accommodates various configurational changes and parameter level changes, making it very innovative and fit for different markets or requirements within the same line of business.

To conclude

The new regulation from CSDR will have far and wide impacts, as it touches various financial firms that trade in the European market. That said, financial firms must develop a buy-in solution with appropriate integration and capacious ways of configuring it. Apart from the European region, this solution can also be scaled to the global market, seeing that the impact of failed trades or settlements on organizations' revenue and brand image is prevalent at any trading venue. Highly adaptive and configurable, buy-in solutions can be easily leveraged at various exchanges and markets around the world. In the future, we can expect the introduction of blockchain and distributed ledger technology in the trade cycle as well.

About the author

Brijesh Shah is an assistant consultant with the Banking, Financial Services, and Insurance (BFSI) business unit at TCS. With over 11 years of experience, he has expertise in manual testing, automation using Selenium, API testing, and performance testing. Brijesh holds a master's degree in Computer Applications from HVPM College, Amravati University, Maharashtra, India.

Awards and accolades



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