Delivering the tools to eliminate settlement fails

Banu Apers, Clearstream's head of Securities Lending and Borrowing, speaks to Bob Currie about their securities lending offering, asset class extension and steps taken to reinforce predictive analytics for lending activities

Clearstream is extending the coverage offered by its Automated Securities Lending (ASL) fails coverage programme, while also enhancing the analytics provided by its Data and Connectivity Solutions division through its Settlement Dashboard and its artificial intelligence-powered Settlement Prediction tool.

Automated lending facilities across CSDs

The traditional ASL service has been live for more than 20 years and regularly enhanced and updated over this period. It provides overnight and intraday lending to enable clients that subscribe to the ASL service to source securities in the instance of settlement failure at Clearstream's International Central Securities Depository (ICSD). This fully automated service, with Clearstream acting as guarantor, protects lenders against counterparty risk should a borrower default on its obligations under the terms of the ASL programme.

"The streamlined onboarding and simplified legal framework allow all Clearstream ICSD clients to participate as lender or borrower in an anonymised structure," says Apers. ASL is also part of its cash financing solutions and accessible to all Clearstream clients.
To extend its coverage, Clearstream released a new fails coverage solution called ASL principal at the end of 2022. This product is Clearstream's cross-(I)CSD solution designed to draw on a single pool of liquidity across the organisation, enabling settlement fails coverage not only at the ICSD (as traditionally offered through ASL), but also for trades settling in central bank money through Clearstream's CSDs for the German and Luxembourg markets which are routed to settle centrally at TARGET2-Securities (T2S), the pan-European securities settlement platform owned and operated by the Eurosystem.

Under this programme, Clearstream offers automated mechanisms to detect potential trade settlement failures. It identifies whether the required securities are held within the lending pool — lendable assets supplied by lenders within the ASL principal programme — and loans are made on a title transfer basis to Clearstream, acting as single counterparty, with collateral transferred simultaneously to the lender on a pledged basis. These securities can then be loaned to the borrower to cover failing settlements.

"ASL principal is a unique solution that is integrated into our harmonised CSD and ICSD solutions, enabling clients to borrow or lend from a single pool of securities regardless of their settlement or custody location," explains Apers. ASL principal combines the automated operational efficiency of the longstanding ASL service with the simplicity and surety offered by having Clearstream acting as the contractual counterparty to the loan. In this programme, Clearstream acts as a single counterparty to all lenders and borrowers, ensuring the anonymity of the programme.

As with ASL, this service is connected to Clearstream's integrated collateral management solution which can automatically optimise the allocation of their liquidity across settlement locations and triparty collateral management activities.

"This forms part of our objective to bring fragmented liquidity pools from a securities assets perspective together into a single location," says Apers. "That is creating a virtual pool of assets from a lender's perspective that can be applied for settlement fails coverage."

Asset class extension

This development is part of Clearstream's wider strategy to extend asset classes within the fails coverage and strategic lending programmes. With close to €17 trillion in assets under custody at the end of Q1 2023, Clearstream has grown beyond its early roots as Cedel, established 50 years ago primarily as a eurobonds house. Currently, Clearstream holds equities valued at more than €5.6 trillion in custody.

Additionally, more than 50 per cent of European exchange-traded funds (ETFs) are held in custody through Clearstream Fund Services. In April 2023, Clearstream Fund Centre established a new bank in Luxembourg dedicated to servicing institutional investors in investment funds and ETFs, with a focus on asset safety, automation and operational efficiency for fund investors.

Apers identifies strong demand for equities and ETFs to meet fails coverage requirements at CSDs settling via the T2S platform. This illustrates the value of extending fails coverage at Clearstream, from a single pool of loan securities via the ASL principal service. "We have been planning strategically to expand our lending solutions across settlement locations, via ASL principal, to meet the needs of participants in these markets," says Apers.

This asset class expansion represents a core part of Clearstream's

2023 development strategy, extending the range of securities and loan availability offered through the fails coverage programme, but also making a wider pool of securities available to clients via the strategic lending programme, ASLplus.

ETF lending within the ASL principal programme reflects a growing interest in lending ETFs as an asset class. Currently, this is still a relatively modest proportion of overall global lending activity, accounting for perhaps €150 billion on loan balances. But with total investment in ETFs globally now at close to €8 trillion, ETF lending is expected to increase as a source of revenue generation on the investment portfolio and as a mechanism for reducing settlement fails.

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"Regulators have taken a close interest in settlement efficiency in the ETF segment, recognising the need to reduce fail rates for this security type but also recognising that trades can fail for longer," says Apers. "Whereas the average duration for a failed equities trade may be 1-2 days, for ETFs the average is typically 3-4 days. Through our asset class extension programme, and by diversifying our loan pool by continuing to add new lenders, Clearstream is playing a central role in improving efficiency in this market segment."

From a financing standpoint, broker-dealer firms are also looking more closely at ETF holdings as part of a wider pool of assets that can be mobilised to access liquidity through collateralised funding transactions.

This aligns with the strength of Deutsche Börse Group across the ETF value chain. Eurex offers trading services for a range of ETF-referenced derivatives, Clearstream Fund Services offers a sophisticated ETF infrastructure, while providing asset servicing for more than €622 billion in ETF assets, and Deutsche Börse-owned Qontigo provides indexing, analytics and risk solutions to a growing number of participants in the ETF marketplace.

Industry commitment

These initiatives collectively align with the efforts of the International Securities Lending Association (ISLA) and other trade associations to reduce settlement fails across the market. "ASL and ASL principal form an integral part of this movement to drive up settlement efficiency through a range of mechanisms, including auto partialling and hold and release," explains Apers.

Automatic partial settlement, also known as autopartialling, is a mechanism that allows part of a failing transaction to settle on an incremental basis. The T2S settlement platform offers a partial hold release function, and CSDs have the ability, under the Central Securities Depositories Regulation (CSDR), to "hold and release" settlement instructions, releasing segments of the original settlement amount. This enables trades to settle partially, rather than being fully failed and having to be resubmitted for settlement.

As this relates to securities lending, loan instructions are input and flagged as "HOLD" until the collateral is received, thereby enabling pre-matching of the settlement instruction. However, this can bring additional challenges when dealing with extended chains of instructions where assets may need to move through complex custody arrangements.

Cultural values

Given the interconnected nature of securities trading markets, a settlement failure can trigger multiple fails in a chain of back-to-back transactions. Depending on the tools employed across the trade flow, such as shaping or partialling, the scale of the failing transactions can quickly escalate.

Since the introduction of fails penalties under the CSDR settlement discipline regime in February 2022, unanticipated delivery failures can result in fines amounting to tens of thousands of euros per day for the failing party.

This not only leads to unnecessary financial losses and a major resource commitment to resolve the settlement discrepancies, but it can also cause reputational damage and a heavy strain on trading and operational relationships. Few firms wish to deal with a failing counterparty when trading in size or when placing trades of high strategic importance.

On a broader scale, a failure-prone marketplace erodes the trust of market players and may drive participants to other locations which offer greater liquidity and more reliable securities deliveries. This failure incurs costs for everyone in the market and fuels an operational culture which can perpetuate settlement risk. For example, an unexpected platform or system failure may result in the non-delivery of a security, triggering a cascade of downstream settlement failures. On other occasions, the price of a bond may change dramatically, leading firms to identify an economic benefit from retaining the security and failing to deliver it for settlement. Although this is a rare occurrence, it is a natural consequence in a post-trade environment where there is insufficient commitment made to address settlement risk.

"To eliminate this operational inefficiency, we offer well-functioning, high-STP fails coverage programmes with a strong depth of liquidity and heavily diversified loan pools that can oil the chain and raise the velocity of securities movements within the system," says Apers.

This will become even more important as markets transition to shorter settlement cycles, as witnessed with the EU's shift to T+2 under the first tranche of CSDR in 2014. Settlement efficiency has returned to the centre of the industry's development planning as the US and Canadian markets prepare for T+1 equities settlement in May 2024, with other major markets expected to follow at some point thereafter.

Settlement monitoring and predictive analytics

Clearstream's efforts in securities lending have recently also gained an additional boost by leveraging Clearstream's established data insights and capabilities. The in-house data scientist team has developed new data solutions for clients to monitor and even predict their collateral, lending and settlement activities.

The Settlement Dashboard provides insights into the clients' past and present settlement performance, as well as the primary factors contributing to settlement fails. Additionally, the Settlement Prediction tool provides forecasts regarding the likelihood of an ISIN settling on time or potentially failing.

"Our intelligent settlement data services help clients to focus on exception management and to review operational processes," says Apers. "The ability to forecast settlement failures is important to mitigate sources of settlement risk and to reduce the financial impact of cash penalties."

Back-office operations can refer to these forecasts throughout the day to prioritise actions and target early intervention for trades flagged as likely to fail. The interactive visualisation tool in the Settlement Dashboard provides a wide range of views, including critical markets, asset classes and counterparties, while enabling clients to benchmark their settlement efficiency against their peers.

These features complement a wider suite of regulatory reporting services, including a settlement fee reporting service that enables users to monitor their compliance with the CSDR settlement discipline regime. Additionally, Clearstream offers a delegated reporting service for the Securities Financing Transactions Regulation (SFTR), linking to the major trade repositories, along with an SFTR reporting API for users who wish to manage their own SFTR data requirements and reporting.

"We are currently developing further data solutions for securities lending and are planning to launch additional solutions later this year," says Apers. Lenders and borrowers will be able to view their activity in near real-time, and lenders will have the opportunity to change the composition of their lending pools depending on the historical and recent performance of their lendable assets.

In closing, Apers notes that Clearstream offers flexible, safe and scalable solutions wherever customers wish to engage in the lending or borrowing of securities or to post or collect collateral from any trading or clearing counterpart. "With access to unique integrated services such as ASLplus and Eurex Repo's GC Pooling, collateral, lending and liquidity solutions, this provides a comprehensive set of services for all treasury and collateral management needs," she concludes.