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Time to address growing JGB settlement fails

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Executive Summary

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Settlement fails have been growing in tandem with foreigners' involvement in the JGB market. The securities industry should improve the efficiency of the post-trade processing as a precaution against future increases in fails affecting institutional investors.

Internationalization of JGB market and settlement fails

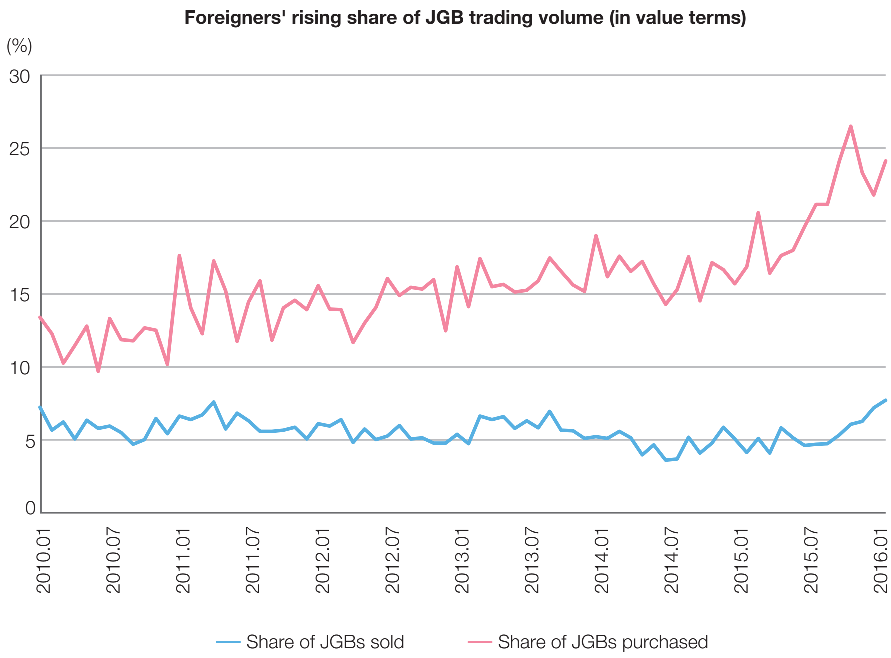
JGB trading is becoming increasingly internationalized. Foreigners' share of total JGB purchases has doubled from around 12% in 2010 to 24% as of February 2016 (Exhibit 1, upper graph). With Japanese pension assets and savings being drawn down amid societal aging, foreigners are an important source of demand for JGBs.

Growth in foreigners' share of JGB trading volume has coincided with an increase in settlement fails, where a trade fails to settle as originally scheduled. Since 2014, monthly fails have exceeded 400 incidents three times. The number of fails during peak fail months has risen since 2014 in a departure from its 2010-13 trend (Exhibit 1, lower graph), though these recent peaks are well below the all-time record 1,600 fails in September 2008, the month of Lehman Brothers' bankruptcy.

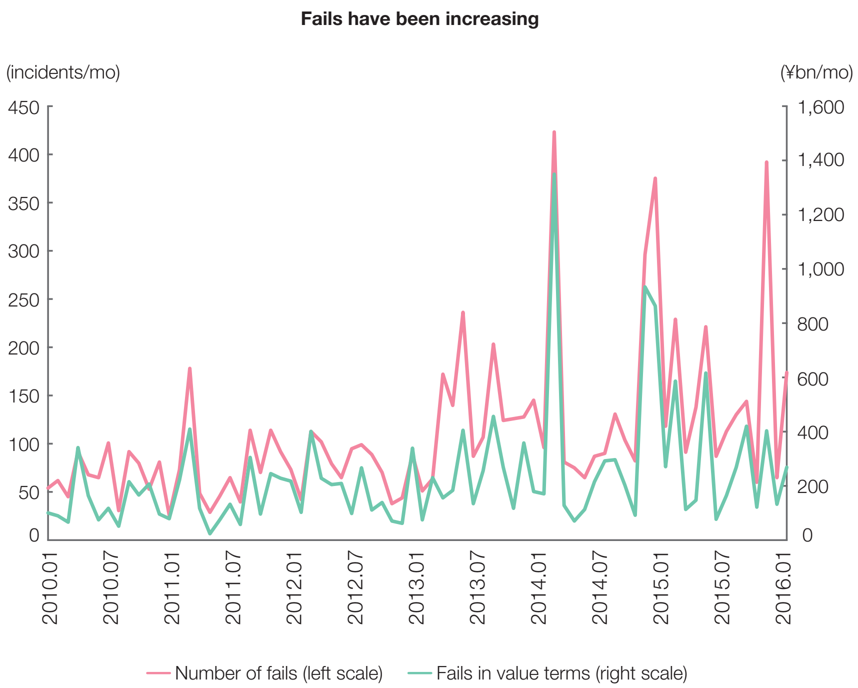
While trades involving foreigners generally tend to be more prone to settlement fails than trades between Japanese counterparties, foreigners' involvement may not be the sole factor behind fails' increased incidence. One reason that trades involving foreigners are more susceptible to settlement fails is that settlement of such trades tends to involve more parties than trades between domestic counterparties. For example, when an overseas fund engages in a JGB trade with a Japanese broker/dealer, delivery takes place through a Japanese bank acting as a sub-custodian under instructions transmitted from the fund's asset manager via an overseas bank acting as a global custodian. When exceptions such as modified delivery instructions arise, the delivery process is prone to time overruns due to cross-border complications or differences in time zones, processing cycles or other such factors.

A second reason is international differences in market conventions. For example,

Exhibit 1: Foreigners' share of JGB trading volume and JGB settlement fails



Source: NRI based on Bank of Japan data



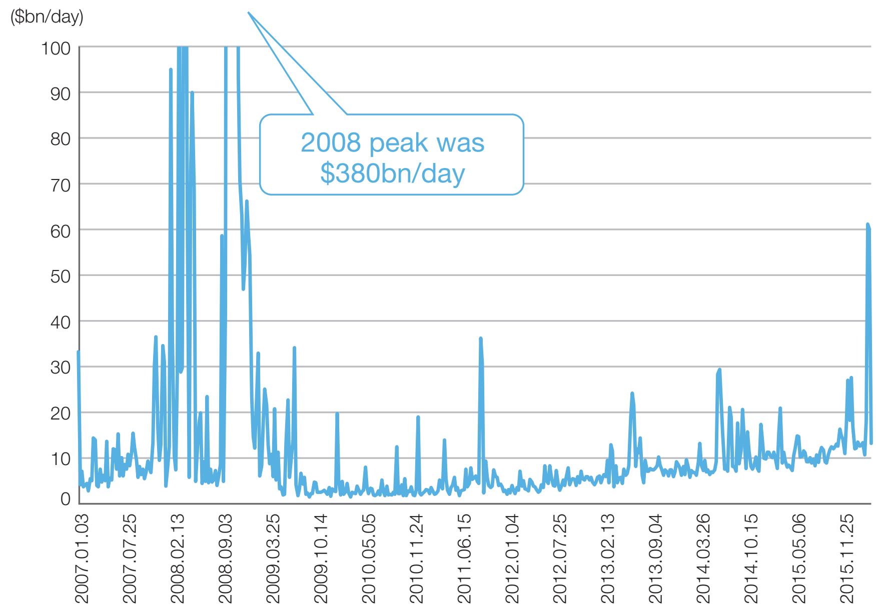
Source: NRI based on Bank of Japan data

Japan has a convention of splitting JGB mega-trades into ¥5bn tranches to limit settlement fails' impact. Foreigners are not always aware of this convention. They sometimes attempt to settle mega-trades as a single trade instead of a series of ¥5bn trades. Such misunderstandings cause settlement mismatches, which tend to necessitate double-checking and/or correction of settlement instructions.

International differences in fail levels

Another point that bears noting is that settlement fails' baseline level is dramatically lower in Japan than in Europe or the US. Even in March 2014, JGB settlement fails' post-crisis peak month, there were only about 400 fails with an aggregate value of roughly ¥1.3trn. In the US, by contrast, monthly US Treasury (UST) securities settlement fails (calculated as the cumulative total of daily fails) were at least around $220bn (roughly ¥24trn) in 2015 according to a survey of primary dealers. Over the four weeks through March 23, 2016, the most recent four-week period for which the requisite data were available as of this writing, UST fails hit a post-Lehman high of $1.1trn (¥121trn). During the peak week of this timeframe, UST fails averaged $60bn per day. While the UST market is admittedly much larger than the JGB market, UST fails exceeded JGB fails' highest post-crisis monthly total by a factor of 100. Nonetheless, the UST market is functioning satisfactorily.

Exhibit 2: UST settlement fails



Source: NRI based on Federal Reserve Bank of New York data

In light of such, overseas markets seem resigned to settlement fails as a routine if undesirable occurrence.

Measures to reduce fails and response thereto

Regulators and market participants have of course been taking action to reduce fails globally. The US, for example, imposed a financial penalty on settlement fails in May 2009 in response to a huge spike in fails in 2008. Specifically, any party that fails to deliver the securities required to settle a trade by the scheduled settlement date must pay its counterparty a so-called fail charge[1)]. In Japan, the Japan Securities Dealers Association formed a working group to reassess industry conventions with respect to settlement fails[2)]. Measures to reduce fails, including fail charges, were adopted in Japan in 2010[3)]. Fails in both the US and Japan were subsequently subdued for several years, but their periodic spikes have been increasing in amplitude in both countries over the past year as mentioned above.

In the case of settlement fails in JGB trades involving foreigners, the broker of the counterparty on the receiving end of the fail typically settles the trade by borrowing securities or funds in the repo market, thereby limiting cascade effects on domestic institutional investors. If fails increase in the wake of continued growth in foreigners' share of JGB trading volume, brokers may no longer be able to fully prevent cascading fails. Given such a risk, the securities industry would be well advised to look into further improving the efficiency of trade processing, post-trade back-office procedures and end-investor reporting as a precaution against future increases in fails affecting institutional investors.

NOTE

1) Fail charges, which are capped at 3%, incentivize hedge funds and other market participants to rectify settlement fails because borrowing securities in the repo market to settle a trade makes more economic sense than allowing a fail to persist. After fail charges were introduced in the US, UST settlement fails dropped to a lower level through 2010 but have been on the rise since 2011.

2) JSDA, Final Report (Framework) of the Working Group concerning the Review of Fails Practice for Bond Trading, (April 20, 2010).

3) In 2010, the JSDA amended its Japanese Government Securities Guidelines for Real Time Gross Settlement with respect to bond settlement fail conventions.

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