ICMA European Repo and Collateral Council

Manufactured payments: ERCC initiative to increase transparency & drive automation

As part of its wider focus on post-trade efficiency, fostering automation and STP have been important objectives for the ERCC. Manufactured payments are a bottleneck in this regard as the process is still very manual and prone to delays. Facilitating further automation of the process requires systematic identification of SFTs at the settlement/CSD level. This would have additional benefits in terms of transparency.

1. Problem statement

- Income payments on securities that have been sold in a repo (e.g. coupons or dividends) are paid by the issuer directly to the repo buyer (as they are the legal owner of the collateral).
- Under the GMRA, the income payment to the buyer of a repurchase transaction triggers an obligation on the buyer to make an immediate and equal payment of income to the seller (buy/sell-backs deal with income payments differently). This is commonly known as a 'manufactured payment'. The buyer has to make a manufactured payment to the seller, even if they have sold the collateral securities. If the buyer has repoed the collateral securities to a third party, rather than sold them short, the third party will be obliged to make a manufactured payment to the buyer in the first repo, starting a chain of payments.
- The manufactured payment process is in most cases still very manual and generally requires the seller to actively claim the coupon payment due from the buyer ahead of payment. As a result, fails and payment delays are relatively common, causing additional effort and cost to firms.
- The ERCC Guide to Best Practice in the European Repo Market (paragraphs 4.15 - 4.21) describes the process around manufactured payments and sets out best practices, clarifying among other things that as, under the GMRA (paragraph 10(a)(5)), a buyer in a repo who fails to make a manufactured payment on the income payment date would be automatically in default, giving the seller the right to trigger close-out netting of all outstanding repos. However, this is a drastic remedy and the right to trigger close-out is therefore not applied in practice. The seller also has the right to deduct the income payment from the repurchase price, but this also is not used.
- The problem is relevant across many markets. Most recently it has been raised by Lloyds Bank specifically in relation to gilt repo in the UK. This has led to a wider discussion, led by the ERCC Operations Group, in terms of potential solutions.

2) Potential solutions and related challenges

- Ideally, the manufactured payments process could be automated at the CSD-level, so that income payments are automatically passed on from the buyer's account to the repo seller once the payment from the issuer is received. Such an automated solution is referred to as 'auto-compensation' and already exists in the US for instance for some securities. However, this would require the CSD to be able to identify an instruction as a repo purchase leg where the seller is entitled to manufactured payments. This is not currently possible in Europe, as market participants do not systematically identify SFTs in settlement instructions, even though a 'transaction type' identifier field is available in SWIFT messages (field :22F). Furthermore, under

CSDR, 'transaction type' is a mandatory field in settlement instructions, but it is not a matching field, which means that differences persist.

- The lack of use of the SWIFT and CSDR transaction type identifiers has been raised as a problem, irrespective of the issue around manufactured payments, especially in the context of the CSDR discussions, most recently in connection with proposed exemptions from settlement discipline provisions, which would require a clear identification of transaction types. Fails reporting requirements for CSDs under CSDR also require, in principle, distinguishing different transaction types, which means that the current data reported by CSDs is not consistent.
- Besides the transaction type identifier, there are additional challenges with the proposal to automate the manufactured payments process at CSD level, which we are keen to explore as part of the Member Survey. One obstacle that was highlighted is that such a solution would not cover indirect participants who access the CSD through intermediaries/custodians, as use of the transaction type identifier may not be sufficient for the CSD to directly identify the original seller. The same is true for internalised settlement. Intermediaries would therefore be required to replicate the process in their internal systems to achieve full automation. There is also the problem of pair-offs and other netting.
- In the absence of an automated solution at CSD level, it has been suggested that it might be sufficient to further strengthen best practice. For instance, in theory, the need for manufactured payments could be avoided by relying on margining. This would require an agreement between parties and internal transfer of income within parties. Punctual payment could also be further encouraged by the introduction of an industry best practice to charge interest on late payments (which is already allowed under the GMRA). However, none of the proposals seems likely to be effective on their own. Perhaps one way forward in terms of best practice could be a range of measures: sending a reminder that the buyer is in default (even if no action is taken); instituting interest for late payment as an industry best practice; encouraging the use of margin to indirectly collect manufactured payments; and use of an identification field and automation of collection and payment at the CSD.

3) Market-specific considerations

a) UK:

- Given the more centralised market infrastructure of Euroclear UK and International (CREST), there may be an opportunity to resolve the issue without regulatory involvement. Euroclear has been closely involved in the discussion so far.
- While more elaborate RPO functionality already exists, this has never been taken up by the market. However, the transaction type identifier ('CSDR transaction type') is available and used by firms, but not consistently.
- As part of the ongoing CREST transformation project, there may be an opportunity to develop functionality that allows for automated processing of repo coupon payments, provided there is sufficient market demand.

b) EU:

- Given the more fragmented market infrastructure, a solution in the EU would likely require regulatory involvement, in order to ensure systematic use of field :22F as a first step towards potential automation at CSD level.
- There are different regulatory initiatives under way which may pick up the issue, specifically the question of the 'transaction type identifier'. In particular, ESMA is consulting on proposed amendments to the CSDR settlement discipline RTS (deadline: 14 April), including on the question of the "transaction type" identifier. Furthermore, there are extensive ongoing discussions related to the upcoming transition to T+1, where the issue of the identifier or manufactured payments more broadly could also be raised.
- Separately, the issue is also being discussed within the ECB/T2S framework, specifically, in the context of the AMI-SeCo Collateral Management Group (CMG), where the ERCC is represented and has raised the issue jointly with Euroclear. Previously, the issue of the transaction type identifier was also considered in the context of the collateral management harmonisation work, which led to a set of best practice recommendations related to the use of the field (see Annex).

Annex: Guidance on Settlement Transaction Type codes for SFTs

Guidance note prepared by the ECB's Collateral Management Harmonisation Taskforce (CMH-TF) (July 2020)

2. *Guidance on usage of Settlement Transaction Types for SFTs*

The SFT counterparties should release the message types corresponding to their role in the transaction and the counterparties should use the same code for the opening leg and the closing leg.

Illustration: In Repurchase Transactions, the seller should always use the same code (REPU) for both the opening and the closing leg. The buyer should always use RVPO:

Role	Code
Seller	**REPU:** The party receiving the cash in exchange for the securities (the **seller**) will see itself as counterparty to a repurchase transaction (**REPU**) and will always send a delivery instruction for the opening leg (and a receive instruction for the closing leg)
Buyer	**RVPO:** The party receiving the securities and delivering the cash (the **buyer**) will see itself as counterparty to a reverse repurchase transaction (**RVPO**) and will always send a receive instruction for the opening leg (and a delivery instruction for the closing leg).

2.1 Opening leg:

Two leg transaction	Explanatory description	Message	Settlement Transaction Type
Repo opening	A repo counterparty sells the bonds in the opening leg	543 / sese.023	REPU
Reverse repo opening	A reverse repo counterparty buys the bonds in the opening leg	541 / sese.023	RVPO
Securities lending initiation	Lending counterparty is lending securities and receiving cash in the opening leg.	543 / sese.023	SECL
Securities borrowing initiation	Borrowing counterparty is receiving the securities and delivering cash in the opening leg.	541 / sese.023	SECB
Sell-buy back: sell	Seller of bonds in a BSB agreement	543 / sese.023	SBBK
Buy-sell back: buy	Buyer of bonds, counterparty of the BSB seller.	541 / sese.023	BSBK

Collateral (giver) out: initiation	Collateral delivery FoP by a collateral giver, first leg. It can be used bilaterally or by TPA. It may be used for transferred or pledge collateral.	542 / sese.023	Collateral (giver) out: initiation
Collateral (taker) in: initiation	FoP receipt of collateral by a collateral taker, first leg. It can be used bilaterally or by TPA. It may be used for transferred or pledge collateral.	540 / sese.023	Collateral (taker) in: initiation

2.2. Closing leg:

Two leg transaction	Explanatory description	Message	Settlement Transaction Type
Repo closing	A repo counterparty receives the bonds back in the closing leg	541 / sese.023	REPU
Reverse repo closing	A reverse repo counterparty delivers the bonds back in the closing leg	543 / sese.023	RVPO
Securities lending return	Lending counterparty is receiving back the securities and giving back the cash in the closing leg.	541 / sese.023	SECL
Securities borrowing return	Borrowing counterparty is delivering back the securities and receiving cash in the closing leg.	543 / sese.023	SECB
Sell-buy back: buy back	The initial seller buys back the bonds in a BSB agreement.	541 / sese.023	SBBK
Buy-sell back: sell back	Initial buyer of bonds, counterparty of the BSB seller, in the return leg delivers the bonds against cash.	543 / sese.023	BSBK
Collateral (giver) out: return	Closure of a general collateral transaction. The collateral giver receives the collateral back FoP in the closing leg. It can be used bilaterally or by TPA. It may be used for transferred or pledge collateral.	540 / sese.023	COLO
Collateral (taker) in: return	FoP return of collateral by a collateral taker, closing leg. It can be used bilaterally or by TPA. It may be used for transferred or pledge collateral.	542 / sese.023	COLI