TMPG | Treasury Market Practices Group

Frequently Asked Questions: TMPG Fails Charges

The following frequently asked questions refer to the Treasury Market Practices Group (TMPG) recommendations for a charge for U.S. Treasury, agency debt and agency mortgage-backed securities (MBS) settlement fails. Please refer to the respective fails charge trading practices for further details.[1]

Revised June 13, 2014

General

Why does the TMPG recommend a financial charge on settlement fails?

Persistent elevated fail levels create market inefficiencies, increase credit risk for market participants and heighten overall systemic risk. In higher rate environments, the time value of money that is lost when delivery is not made as contracted provides an incentive to sellers to deliver bonds as agreed. Given that this incentive is smaller in low short-term rate environments, sellers are less sensitive to the timeliness of delivery. The TMPG recommends a financial charge to provide an incentive to sellers to deliver securities in a timely fashion and to therefore reduce overall fail levels.

Do the settlement fails charges represent a significant burden for market participants' back offices, particularly for agency MBS settlement fails?

While many market participants experienced an initial increase in operational resource requirements following the respective effective dates of the fails charges, ongoing operational resource use eased as fails declined after the fails charge practices were broadly adopted.

For the agency MBS fails charge trading practice, the TMPG initially included a resolution period as an operational accommodation when the agency MBS trading practice was first introduced, recognizing that clearing and settlement in the agency MBS market is operationally more intensive than clearing and settlement in the Treasury and agency debt markets. The resolution period consisted of the two business days following contractual settlement date; a fails charge was not applicable to a fail that settled on either of these two days. The TMPG subsequently removed the resolution period, effective on July 1, 2013, when the Group assessed that the resolution period was no longer necessary given that most market participants were managing the fails claim process effectively.

Won't fails charges serve as an incentive for bad behavior?

Existing TMPG guidance advocates strongly against practices that intentionally inhibit the efficient clearing of the market. Moreover, engaging in manipulative or fraudulent activity may subject a firm to legal and regulatory liability.

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[1] The "U.S. Treasury Securities Fails Charge Trading Practice" and the "Agency Debt and Agency Mortgage-Backed Securities Fails Charge Trading Practice," published by the TMPG and the Securities Industry and Financial Markets Association (SIFMA) are available at: http://www.sifma.org/services/standard-forms-and-documentation/fails-charge-trading-practices/.

What is the effective date of the recommended fails charges?
The TMPG recommends that the fails charges apply to transactions in agency debt and agency MBS entered into on or after February 1, 2012, as well as to transactions that were entered into prior to, but remain unsettled as of, February 1, 2012. For agency debt and agency MBS transactions entered into prior to, and unsettled as of, February 1, 2012, the TMPG recommends that the fails charge begin accruing on the later of February 1, 2012, or the contractual settlement date. The TMPG recommends that Treasury security transactions entered into on or after May 1, 2009, be subject to the fails charge for U.S. Treasury securities.

Is adoption of the TMPG recommendations mandatory?
Although the TMPG strongly recommends the adoption of the fails charge trading practices, the TMPG's market practice recommendations are voluntary. Even so, all fails in Treasury transactions executed between Fixed Income Clearing Corporation (FICC) members are subject to a fails charge.[2] Fails in Fannie Mae, Freddie Mac or Federal Home Loan Bank debt instrument transactions executed between FICC members are subject to a fails charge as of February 1, 2012.[3]

How are the fails charges treated for U.S. tax purposes?
Tax implications of the fails charges will undoubtedly vary across firms and institutions, and each participant should consult with its own tax advisors. The Internal Revenue Service (IRS) has issued final regulations that prescribe the source of income received on a qualified fails charge under section 863 of the Internal Revenue Code (see http://www.gpo.gov/fdsys/pkg/FR-2012-02-21/pdf/2012-3909.pdf). The final regulations generally apply to qualified fails charges paid or accrued on or after December 8, 2010.

With certain exceptions, the final regulations treat a fails charge received by a non-U.S. person as foreign source income, which generally results in no U.S. withholding tax on the fails charge. The final regulations apply to a fails charge paid pursuant to a trading practice endorsed by the TMPG for U.S. Treasuries, as well as for debentures issued by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, and also to agency pass-through mortgage-backed securities issued or guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac.

Fails charge applicability

Do the fails charges apply to all Treasury securities, agency debt securities and agency MBS?
The TMPG has recommended that fails charges apply to all U.S. Treasury securities; all agency debt instruments issued by Fannie Mae, Freddie Mac and the Federal Home Loan Banks, regardless of time to maturity or structure; and agency pass-through MBS issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. The TMPG has not recommended that a fails charge apply to collateralized mortgage obligations or other structured mortgage securities.

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[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. The SEC's approval notice is available at http://www.sec.gov/rules/sro/ficc/2009/34-59802.pdf.

[3] The applicable rule filing SR-FICC-2011-08 is available on FICC's website at http://www.dtcc.com/legal/rule_filings/ficc/2011.php. The SEC's approval notice is available at http://www.sec.gov/rules/sro/ficc/2011/34-65632.pdf.

Do the fails charges apply to agency multifamily mortgage-backed and project loan securities?
Yes, agency multifamily and project loan securities such as Freddie Mac K Certificates, Fannie Mae Delegated Underwriting and Servicing bonds, Ginnie Mae Construction Loan/Project Loan Certificates, are all within the scope of the fails charge practice recommendation.

Do the fails charges apply to cash and financing transactions?
A fails charge is applicable on failing securities regardless of whether they are related to repo, securities lending/dollar roll, option, forward or purchase transactions, including specified pool and to be announced (TBA) transactions. In short, a fails charge is recommended for all delivery-versus-payment settlement obligations in the applicable security types, regardless of the source of those settlement obligations.

Does the TMPG fails charge practice recommendation contemplate cross honoring fails claims when a free delivery fail causes a settlement fail in another transaction?
No, the intent of the TMPG fails charge is to reproduce the economic consequences of a settlement fail in a higher nominal rate environment. As such, fails on free deliveries are outside the scope of the TMPG practice recommendation. That said, it was not the intent of the TMPG best practice recommendation to preclude counterparties in such a scenario from separately agreeing to compensate a failed-to party if they determine that to be a desired element of their trading relationship.

Does the TMPG fails charge practice recommendation apply to round robins and pair-offs?
In general, fails charges should apply to all delivery-versus-payment ("DVP") transactions. In the case of two or more DVP transactions that (a) have the same original contractual settlement date and (b) are ultimately settled via a pair off or round robin, parties need not apply the fails charge. This clarification should remove the risk that some participants might delay settlement in the hope of ultimately pairing off or settling through a round robin, thus avoiding the application of the fails charge. The TMPG is not recommending that market participants revisit or revise such scenarios where the fails charge has been applied in a different manner in the past.

The examples below are meant to clarify the recommended practice with respect to pair-offs:

Example 1 (settlement by pair-off):
If two DVP transactions that have different original contractual settlement dates (with the two transactions failing to settle for a different number of days), are settled through a pair-off, then two fails charge claims are generated.

Example 2 (settlement by pair-off):
If two DVP transactions that have the same original contractual settlement dates (with both transactions failing to settle for the same number of days) are settled through a pair-off, then no fails charge claims are generated.

The examples below are meant to clarify the recommended practice with respect to round robins:
Note: For each transaction within a round robin settlement chain, we assign a number which corresponds to the length of the fail for each transaction. For example, 3-3-3-3 would indicate that all four transactions had failed for 3 days after the original contractual settlement date.

Example 3 (settlement by round robin):
If a chain of DVP transactions that have the same contractual settlement date is settled by round robin and all transactions in the chain have been failing for the same number of days, no fails charge claims

are generated. For instance the following chains settled by round robin would not be subject to fails charge claims:
3a. 2-2-2-2
3b. 5-5-5-5
3c.7-7-7

Example 4 (settlement by round robin):
If a chain of DVP transactions is settled by round robin and any transaction in the chain has a different original contractual settlement date, all transactions in the chain should generate a fails claim charge. Below are some examples to clarify this treatment. For instance, the following transaction lengths post original contractual settlement dates are examples where all transactions would be subject to fails charge claims:
4a. 5-5-5-7
4b. 5-7-5-7
4c. 4-8-6

Fails charge calculation

What is the recommended rate charged on fails?
For fails in Treasury and agency debt securities, the TMPG recommends 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.

For fails in agency MBS, the TMPG recommends that a settlement fails charge be calculated each day based on the greater of (a) 2 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 2 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 2 percent per annum.

* Note: The current TMPG reference rate is the target federal funds rate specified by the Federal Open Market Committee (FOMC) 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
(see: http://www.newyorkfed.org/markets/omo/dmm/fedfundsdata.cfm).

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:

$$C = \frac{1}{360} * 0.01 * \max(B - R, 0) * P$$

where: C = fails charge amount, in dollars

B	=	2, when calculating the fails charge for an agency MBS transaction, and 3, when calculating the fails charge for a U.S. Treasury or agency debt transaction
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 on one rate level for Treasuries and agency debt and another rate level for agency MBS?
The TMPG recommendation is designed to give sellers an economic incentive to deliver securities even when the federal funds rate is low. Experience shows that Treasury and agency debt fails have rarely become widespread and chronic if the fed funds 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.

The TMPG has recommended a lower charge level for the agency MBS market, given structural differences in this market compared to the agency debt and Treasury markets. These differences include monthly settlement conventions that make fails more persistent and more challenging to resolve quickly. The TMPG believes that a lower charge can be effective in reducing agency MBS fails, while at the same time supporting liquidity in the market. If fail levels do not decline satisfactorily within a few months after the charge takes effect, the TMPG will consider raising the charge level.

Why are the fails charges calculated on trade proceeds, instead of current face?
Calculation of the fails charges based on current face would require significant systems changes across market participants, as existing fail claim processes typically take data from settlement systems, which typically capture fail data based on settlement proceeds. Because the use of current face would be complex and costly, the TMPG is recommending that the calculation be based on trade proceeds.

What happens if there is a change in the TMPG reference rate during the period of a delivery fail?
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).

Can you provide an example of the charge for a failure to deliver a Treasury security? In addition, how would a claim be calculated if a fail extends over month end?
Assume that a buyer purchases a 2-year Treasury note for settlement on a Friday, October 28, 2011, 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 Wednesday, November 2, 2011. The seller would be charged based on a settlement failure for 5 days. Under this scenario, the buyer would submit a claim for a fails charge cumulated over 5 days—Friday, October 28 through Tuesday, November 1—by the 10th business day of December, and the seller would then pay or reject the claim by the last business day of December.

Assume that the TMPG reference rate for the duration of the fail is 1 percent. The fails charge for each of the 5 days would be calculated as follows:

$$C = \frac{1}{360} * 0.01 * \max(3 - 1, 0) * \$100{,}000{,}000$$

$$C = \frac{1}{360} * 0.01 * 2 * \$100{,}000{,}000$$

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

The claim amount would be the sum of these charges over the 5 days, or $27,777.78.

Can you provide an example of the charge for a failure to deliver an agency MBS?
A failing party delivers 4 $1 million pools to a given account on the 3rd business day (Friday) following contractual settlement date (Tuesday). Assuming a reference rate of 0, the fails charge for each of the 3 days for each of the pools would be calculated as follows:

$$C = \frac{1}{360} * 0.01 * \max(2 - 0, 0) * \$1{,}000{,}000$$

$$C = \frac{1}{360} * 0.01 * 2 * \$1{,}000{,}000$$

$$C = \$55.56$$

The claim amount would be the sum of the charges for all fails between 2 legal entities that are counterparties to one another in a transaction over the course of a month. Assuming the 3 pools referenced above were the only fails for the month, the claim amount would be $666.67 ($55.56 * 3 days * 4 pools). (See below for further detail on aggregation of fails charges at the account level.)

<u>**Fails charge claims and payment**</u>

Is there a minimum threshold for fails charges?
The TMPG currently recommends an exemption for accrued fails charges of less than or equal to $500 on fails in U.S. Treasury securities and agency debentures, on a per trade basis.[4] The TMPG also recommends an exemption for aggregated cumulative fails charges of less than or equal to $500 on agency MBS fails between 2 legal entities that are counterparties to one another in a transaction for a given calendar month.

When a transaction is executed by an investment manager on behalf of multiple principals and the allocation of the transaction to the principals is disclosed to their counterparty, each principal is a distinct party for purposes of calculating a fails charge. If a principal utilizes more than one investment

[4] Based on allocated trade amounts, that is, if an $8 million trade is allocated into $5 million and $3 million tickets, then the relevant trade sizes become $5 and $3 million. This allocation must be known by both counterparts before the original settlement date.

manager, each investment manager's transaction executed on behalf of the principal constitutes a transaction by a distinct party for purposes of calculating a fails charge (i.e., one investment manager's transaction is not aggregated with other investment managers' transactions executed on behalf of the same principal).

Although the TMPG believes that the ideal threshold for fails charges is zero for all market participants, the TMPG believes that these minimum thresholds facilitate adoption of the fails charge trading practices and minimize operational burden associated with adoption of the trading practices. The TMPG will revisit the threshold recommendations if needed.

The FICC has no minimum threshold for accrued fails charges due to the nature of FICC netting and novation.

What is the $500 minimum account-level claim threshold for the agency MBS fails charge?
A failing party is not subject to a fails charge if the sum of the cumulative fails charges for all delivery failures from the failing party to a separate legal entity for a given month is less than or equal to $500.

Can you provide examples of how the $500 minimum account-level claim threshold for the agency MBS fails charge works?

Example 1
Over the course of a calendar month, Firm A accrued $200 in Fails Charges for Delivery Failures to Firm B, while Firm B accrued $600 in Fails Charges for failing to deliver agency MBS to Firm A. Prior to the end of such calendar month, all outstanding Delivery Failures between the two firms are resolved. Firm A would submit a claim to Firm B for $600, while Firm B would not submit a claim to Firm A, since the Fails Charges for Delivery Failures by Firm A in that calendar month were less than $500.

Example 2
An investment manager (Asset Manager 1) executes Agency MBS transactions on behalf of three investment funds (Fund A, Fund B, and Fund C). The counterparty on the transactions is a broker-dealer (Securities Trading LLC). Fund A, Fund B, and Fund C each have accrued $200 in aggregate Fail Charges for Delivery Failures to Securities Trading LLC for the month of June.

Fund A, Fund B, and Fund C would each be considered to be a distinct Failing Party. Securities Trading LLC, as the Non-Failing Party, would not be entitled to collect any of the Fail Charges from Fund A, Fund B, or Fund C because the amount of each of their aggregate Fails Charges for the calendar month is less than or equal to $500.

Example 3
An investment fund (Fund D) utilizes three investment managers (Asset Manager 2, Asset Manager 3, and Asset Manager 4). Asset Manager 2, Asset Manager 3, and Asset Manager 4 each execute Agency MBS transactions on Fund D's behalf. The counterparty on the transactions is a broker-dealer (Securities Transactions LLC). Fund D has accrued $100 in aggregate Fail Charges for Delivery Failures to Securities Transactions LLC for the month of June on transactions executed on Fund D's behalf by Asset Manager 2. Fund D has accrued $200 in aggregate Fail Charges for Delivery Failures to Securities Transactions LLC for the month of June on transactions executed on Fund D's behalf by Asset Manager 3. Fund D has accrued $300 in aggregate Fail Charges for Delivery Failures to Securities Transactions LLC for the month of June on transactions executed on Fund D's behalf by Asset Manager 4.

Fund D's transactions executed on its behalf by Asset Manager 2, Asset Manager 3, and Asset Manager 4 would each be considered to be transactions by a distinct Failing Party. Securities Transactions LLC, as the Non-Failing Party, would not be entitled to collect any of the Fail Charges from Fund D because the amount of the aggregate Fails Charges on transactions executed on Fund D's behalf by each of Fund D's investment managers for the calendar month is less than or equal to $500.

Example 4
An investment fund (Fund E) utilizes three investment managers (Asset Manager 5, Asset Manager 6, and Asset Manager 7). Asset Manager 5, Asset Manager 6, and Asset Manager 7 each execute Agency MBS transactions on Fund E's behalf. The counterparty on the transactions is a broker-dealer (Securities Dealer LLC). Securities Dealer LLC has accrued $100 in aggregate Fail Charges for Delivery Failures to Fund E for the month of June on transactions executed on Fund E's behalf by Asset Manager 5. Securities Dealer LLC has accrued $200 in aggregate Fail Charges for Delivery Failures to Fund E for the month of June on transactions executed on Fund E's behalf by Asset Manager 6. Securities Dealer LLC has accrued $300 in aggregate Fail Charges for Delivery Failures to Fund E for the month of June on transactions executed on Fund E's behalf by Asset Manager 7.

The transactions executed on Fund E's behalf by Asset Manager 5, Asset Manager 6, and Asset Manager 7 would each be considered to be transactions entered into by Securities Dealer LLC with a distinct Failing Party. Fund E, as the Non-Failing Party in each set of transactions, would not be entitled to collect any of the Fail Charges from Securities Dealer LLC because the amount of Securities Dealer LLC's aggregate Fails Charges on each set of transactions executed on Fund E's behalf by Fund E's investment managers for the calendar month is less than or equal to $500.

If a seller attempts to make a partial delivery of 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 securities underlying a transaction. As such, a buyer who fails to receive the full amount of securities 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 than 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, is it possible for the seller to assign the buyer's claim and in effect step out of the claim process?
No, not under the TMPG trading practice. 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, in what is currently a bilateral system, the TMPG believes that assignments of fails charges will only lead to prolonged deferrals of payments and increased implementation costs.

What does my firm need to do 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 in respect of the fails charge. This framework includes (1) trading practices providing precise detail regarding the fails charge, (2) suggested language, referring to the trading practices, to be included in transaction confirmations and (3) a suggested form of notice, to be sent by dealers to counterparts, that transactions will be conducted

in accordance with the trading practices. These documents have been published and will be maintained by SIFMA on its website. The foregoing are suggestions developed by the TMPG, but market participants should consult with their own counsel and advisors to determine the appropriate approach that they wish to take with regard to these matters.

How often will fails charge claims be assessed?
The TMPG recommends that fails charges accrue over the life of a delivery failure, but that claims for such charges be issued monthly, by the 10th business day of the month following the month in which the delivery failure is resolved. A delivery failure spanning more than one calendar month would result in a single claim, based on the fails charge over the entire duration of the fail.

When is a claim 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 10th 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 are submitted.

Why does the TMPG recommend that fails charges be paid after a transaction settles, rather than on a monthly accrual basis over the life of a fail?
Given that most asset manager and custodian systems are based on trade settlement, payment of 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, as well as a TMPG working group comprised of buy-side, custodian, dealer and clearing bank participants in the agency MBS market.

What if a claim is submitted after the 10th business day of the month following the resolution of a delivery failure?
The timeframe set forth in the trading practices for claim submission is not intended to provide a basis to reject a claim submitted in a reasonably timely manner, but instead sets a convenient administrative default which all market participants should endeavor to meet. Thus, the TMPG recommends that claims submitted in a reasonably timely manner, but after the recommended time frame, nonetheless be paid or rejected in a timely manner. Counterparties should resolve any disputes as to the reasonable timeliness of any claim submission bilaterally and in good faith.

What happens if claims are not paid on time? Are there any guidelines on how to handle disputed claims?
The TMPG expects that market participants will handle claim disputes bilaterally and in good faith.