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When the Back Office Moved to the Front Burner: Settlement Fails in the Treasury Market after September 11

23 Pages

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Abstract

Settlement fails, which occur when securities are not delivered and paid for on the date scheduled by the buyer and seller, can expose market participants to the risk of loss due to counterparty insolvency. This article examines the institutional and economic setting of the fails problem that affected the Treasury market following September 11 and describes how the Federal Reserve and the U.S. Treasury responded. The authors explain that fails rose initially because of the physical destruction of trade records and communication facilities. Fails remained high because a relatively low federal funds rate and investor reluctance to lend securities kept the cost of borrowing securities to avert or remedy a fail comparable to the cost of continuing to fail. The fails problem was ultimately resolved when the Treasury increased the outstanding supply of the on-the-run ten-year note through an unprecedented "snap" reopening. The article also suggests other ways to alleviate chronic fails, such as the introduction of a securities lending facility run by the Treasury and the institution of a penalty fee for fails.

Keywords: Settlement fails, Treasury market, repurchase agreement, repo market, securities lending, September 11

JEL Classification: G18, H63, E58

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