CSDR Refit

Proposed refinements to improve the operation of the Mandatory Buy-in regime, in the event that it remains a regulatory requirement

An ICMA briefing note

September 6, 2022

<u>Option 1</u>

ICMA continues to question the appropriateness of mandating buy-ins through regulation, which poses very real risks for market liquidity and stability in the EU, as well as undermining the EU's competitiveness as a global capital marketplace. ICMA would advocate the removal of a buy-in regime from CSDR.

<u>Option 2</u>

ICMA would further advocate that if MBIs are to be applied as a last resort, this should be done through market regulation, and not through post-trade regulation. This is because buy-ins are market transactions executed by trading parties, and are not a post-trade process.

<u>Option 3</u>

While removing the MBI requirement from CSDR would be preferable, ICMA is broadly supportive of the European Commission's proposed revisions to the CSDR mandatory buy-in framework, which was clearly problematic for a number of reasons. Accordingly, the proposed 'two-step approach', along with practical changes to the buy-in design, is a welcomed development. If co-legislators decide to maintain this approach, ICMA believes that some further refinements to the framework would help to improve its effectiveness while minimising risks to financial stability:

- **(i) The assessment process for the two-step approach should be more flexible and include the possibility to recalibrate cash penalties;**
- **(ii) Securities financing transactions (SFTs) should be exempted from any MBI requirement;**
- **(iii) It needs to be clarified that symmetrical payments of the differential also applies to cash compensation as well as to buy-ins.**

ICMA would add that in the event that MBIs are applied to a particular security or transaction type, sufficient notification is given to the market to allow participants to make the necessary operational and contractual arrangements to support implementation.

This briefing note provides background information for these key proposals, as well as proposed revised text for the three refinements (which can be found in Annexes 1-3).

Background: How market buy-ins are used today

A buy-in is a market-based remedy whereby securities in a failing transaction are sourced from a third-party holder. The intended outcome of a buy-in is to resolve the settlement fail and to restore the parties to the transaction to the economic position they would have been in had the original trade settled as intended.

Buy-ins are a common **risk management tool** used in certain markets, such as the non-cleared international bond markets.[1] They are usually a contractual right, under the terms of a trade, that allow a trading party to source securities from an alternate source in the event of the settlement of a purchase failing. The delivery from the original selling trading party is then canceled, and any difference in the price (plus accrued interest, brokerage costs, etc.) between the replacement transaction ('the buy-in') and the original trade is settled between the purchasing party and the original seller, ensuring that the purchasing party is restored to the economic position they would have been in had the original purchase settled (i.e. they are neither better nor worse off). In other words, as opposed to cash penalties, **buy-ins are a restorative remedy and not intended to penalise the failing party nor compensate the non-failing party**.

While buy-ins are not uncommon, trading parties often use buy-ins as a last resort, and as part of wider considerations around market liquidity and risk. For instance, some investors are amenable to tolerating settlement fails for a period of time if (i) it means that they can get exposure to the security of choice and (ii) they are happy with the credit risk of their counterparty. Furthermore, buy-ins can be extremely expensive for the failing party, particularly in less liquid securities. For buy-ins to be effective, the purchasing party will need to source them for 'guaranteed delivery', which usually comes at a significant premium to the market price. While the trading parties will settle the difference between the original price and the buy-in price between themselves, the difference between the buy-in price and the current market price (where the securities are marked-to-market or resold) will be borne by the failing party. Finally, buy-ins are not straightforward, not least since it may be difficult to find the securities, as well as requiring extensive time and coordination between traders, operations, and legal. Importantly, buy-ins are market transactions, not a post-trade process. When buy-ins are not executed appropriately, this can lead to economic, legal, and reputational risks for the party issuing the buy-in. (Annex 4 provides an illustration of market buy-ins and the associated costs for the failing party.)

How are mandatory buy-ins different?

CSDR mandatory buy-ins (MBIs) seek to make buy-ins compulsory after a set period of days. **They are no longer a risk management or commercial consideration that can be used at the discretion of the non-failing party**. Furthermore, in the case of non-centrally cleared trades, the Level 1 regulation does not place the obligation on the relevant trading parties, as is the case with market buy-ins today, but rather it attempts to put the obligation on CSD participants: i.e. settlement agents or custodians, who are

[1] The ICMA Buy-in Rules, part of the ICMA Secondary Rules & Recommendations, provide an example of a widely available contractual buy-in remedy, used in the international bond markets.

usually not party to the transaction. While the Level 2 attempts to move the obligation to the trading parties in line with contractual reality, it remains constrained by the Level 1 text, which still refers to 'CSD participants' and not trading parties.

The key differences between CSDR buy-ins and standard market buy-ins are summarised in Annex 5. It can be seen that MBIs differ from market buy-ins structurally, legally, and even economically.[2]

Option 1 (preferred): Remove MBI provisions from CSDR

ICMA maintains that the best option from a market stability perspective would be to remove the MBI provisions from CSDR entirely.

MBIs, as opposed to discretionary, contractual, market buy-ins, would have significant detrimental impacts on the ability and willingness of market-makers to perform their role, particularly in less liquid securities, such as corporate bonds, emerging market bonds, and the sovereign debt of smaller EU economies. This is explained in further detail in Annex 6, along with some of the findings of ICMA's 2019 impact assessment.

An MBI requirement would also be extremely destabilising in times of market stress and heightened volatility, particularly when this also results in an increase in settlement fails, as was the case during the 2020 COVID-19 induced market turmoil. Annex 7 provides analysis of how the MBI framework would have affected EU sovereign and corporate bond markets, had it been in effect at the time.

Option 2: Apply MBIs through market regulation

Should MBIs be deemed necessary for a particular security or transaction type, upon further assessment, this should be applied through market regulation (either as a standalone regulation or as part of MiFIR) and not as part of CSDR or any other post-trade regulation.

As ICMA has suggested previously, many of the implementation (and enforceability) challenges related to the CSDR MBI framework stem from the fact that any legal requirements covering a buy-in transaction would be better achieved through market regulation, not post-trade regulation. Buy-ins are not a post-trade process. They are market transactions, executed between trading parties, with associated market risk. In most cases these will not be the 'CSD participants' referred to in the Regulation. In other words, what the CSDR MBI framework effectively attempts to do is to impose a requirement for a trading entity to enter into a market transaction through a regulation that does not directly apply to them. In many cases that trading entity will not even be an EU regulated entity.

Hence, in the event that the Commission determines that an MBI requirement is appropriate for a particular instrument or transaction type in the EU, **ICMA would strongly recommend that it apply this through market regulation, targeted at the relevant, regulated trading parties**. This would be far more effective, and significantly less complex, than trying to apply the law through contractual arrangements 'along the transaction chain'.

[2] Although it is noted that the EC proposal seeks to address the asymmetry in the payment of the buy-in and cash compensation differentials.

Option 3: Keep MBI provisions in CSDR, but with certain refinements

In the case that the full removal of MBIs from CSDR is not possible, ICMA suggests three refinements to the European Commission's proposal intended to improve its effectiveness while reducing potential risks to market stability.

Refinement 1: allow for more flexibility in the two-step approach

The two-step approach provides that an implementing act can be used to apply MBIs to a particular financial instrument or transaction type *"where the Commission considers that those measures constitute a proportionate means to address the level of settlement fails in the Union and that, based on the number and volume of settlement fails, any of… [three outlined] …conditions is met"*.

While ICMA is broadly supportive of the approach, it feels that there could be more scope for flexibility. ICMA would propose that the three outlined conditions for assessing whether MBIs are a proportionate means to address settlement fails should be considered in combination, rather than as independent criteria.[3] **A more holistic assessment of the impact, and cause, of settlement fails would seem to be a more robust, and even flexible, approach than relying on a single (potentially objective) benchmark**.

Such methodology should also take into consideration the specific asset class, recognising that not all securities are alike, underlying market structures, liquidity conditions (noting that these are variable), possible frictions related to the interdependencies of multiple market infrastructures,[4] as well as existing contractual frameworks or market initiatives for resolving settlement fails. Data integrity will also be key in any analysis used to determine trends in settlement efficiency rates, as will identifying and accounting for any data and methodology inconsistencies in any comparison with other jurisdictions. The work of the Eurosystem related to settlement efficiency on the TARGET2-Securities platform[5] also helps to highlight the challenges in establishing reliable and consistent metrics for measuring settlement fails.

As the Commission seems to anticipate in its proposal, there remains a question mark over whether the current calibration of the penalty mechanism,[6] with respect to the fees applied, are appropriate, particularly in light of a very low or negative interest rate environment. As we move to a higher (positive) interest rate environment this may help, and this may even be more impactful than penalties. But ICMA would recommend periodic assessments of the impact of penalties on settlement efficiency rates for different asset classes, and to **consider a recalibration of the relevant fees, where appropriate, rather than moving directly to MBIs**. As part of the assessment the Commission should

[3] The conditions outlined in the regulation being: (i) penalties have not achieved the desired outcome; (ii) settlement efficiency rates in the EU are not comparable with similar third country markets; and (iii) the level if fails in the EU is likely to have a negative impact on financial stability.
[4] In some cases securities are transacted across multiple CSDs, CCPs, and involving different custodians and settlement agents, increasing the possibility for late settlement.
[5] See: https://www.ecb.europa.eu/paym/intro/publications/html/ecb.targetsecar202205.en.html
[6] ICMA has been supportive of a cash penalty framework for EU bond and repo markets, particularly in a low interest rate environment. In line with this, ICMA has worked with its members and the broader industry in facilitating the implementation of the CSDR penalty regime, including the provision of market best practice and FAQs.

also be able to consider other settlement efficiency tools, such as shaping or partial settlement, which may be more appropriate and effective than MBIs.[7]

Similarly, ICMA would also recommend the ongoing monitoring on the impact of penalties on market liquidity across different asset classes to ensure that they are not detrimental, particularly as market interest rates increase.

Proposed revisions to the drafting to support this refinement can be found in Annex 1.

Refinement 2: exempt securities financing transactions from MBI requirements

While the Commission proposal introduces a number of critical amendments to the buy-in framework, one key area of concern that remains is the potential application of MBIs to securities financing transactions (SFTs). This relates specifically to Article 7(4)(b) in the Regulation, which remains in the proposal: *"for operations composed of several transactions including securities repurchase or lending agreements, the buy-in process referred to in paragraph 3 shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective".*

While this open the possibility to exclude very short-dated SFTs from the requirements,[8] ICMA would strongly disagree with the inclusion of any SFTs in an MBI regime. Firstly, SFTs are not independent outright sales or purchases of securities: they are the short-term loan of securities. Particularly in the case of a failing start-leg, neither a buy-in nor cash compensation would make economic sense from the perspective of both parties, and certainly would not restore either to the position they would have been in had the original SFT settled.

Secondly, SFTs are broadly executed under established contractual arrangements (such as a GMRA or GMSLA) that include specific provisions designed to protect the non-failing party in the case of a settlement fail (on either leg). Imposing an MBI regime on such "documented" SFTs would undermine the integrity of these contractual, transaction specific remedies.

Thirdly, documented SFTs are subject to daily (and even intra-day) margining. Thus, the credit exposure for a failed-to party is significantly less than that of a failing cash transaction.

Finally, SFTs are frequently used to help resolve settlement fails. In other words, they are a fundamental tool for improving settlement efficiency. Bringing SFTs into scope of a (highly disproportionate) MBI regime would be a disincentive to lending securities, and would therefore be counterproductive to the objectives of settlement discipline.

In its published opinion on the proposed amendments to CSDR, the ECB also urges the EU legislator to exclude SFTs from the scope of MBIs, noting that SFTs do not create an outright open position and that MBIs would not be a proportionate remedy.[9]

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[7] See: ICMA's white paper: *Optimising settlement efficiency* (February 2022)
[8] Although a degree of ambiguity remains, such as in the case of 'open SFTs'
[9] See:
https://www.ecb.europa.eu/pub/pdf/other/en_con_2022_25_f_sign~5d1a092f24.en.pdf?362f3efce375621569f1bcae7662ee6a

ICMA would therefore recommend that the proposal be revised to provide an explicit exception for SFTs.

Proposed revisions to the drafting to support this refinement can be found in Annex 1.

Refinement 3: Clarify that the payment symmetry also applies to cash compensation

While the proposed revisions to the MBI framework aim to address the issue of asymmetrical payments of the buy-in or cash compensation differential (as described in Recital (7) of the proposal), there remains a potential ambiguity in the proposed revised text (Article 7) with respect to cash compensation. The proposed revision to Article 7, paragraph 6 is very clear in facilitating symmetrical payments in the case of buy-ins. However, there is no revision to Article 7, paragraph 7, which seems still to imply an asymmetrical treatment in the case of the cash compensation differential.[10]

Furthermore, ICMA would recommend not referring in the Level 1 text to the buy-in failing as a condition for cash compensation, since the risk involved in the buy-in process can be significantly reduced by completing the buy-in on successful execution, rather than successful settlement: a consideration that could be better addressed in the Level 2.

Proposed revisions to the drafting to support this refinement can be found in Annex 3.

In the event that MBIs are ever applied to a particular market, it will be important that enough time is provided for the relevant market participants to prepare for implementation. This will not only likely require significant investment in staff, processes, and automation, but also extensive contractual papering.

Conclusion

ICMA continues to advocate the complete removal of a regulatory MBI requirement from CSDR in line with recommendations put forward by the ECB.[11] In case it is decided to maintain MBI provisions in CSDR, we are broadly supportive of the Commission proposal and amendments to the MBI framework, including the two-step approach. However, ICMA believes that this can be further enhanced with the three proposed refinements outlined in this briefing note (a more flexibility in the two-step approach, including the recalibration of penalties, the exemption of SFTs, and clarification of the payment

[10] The asymmetry in the original regulation is one of the key implementation challenges to MBIs, since it would create distortive and unpredictable economic outcomes for the buy-in, undermining its purpose as a restorative remedy to resolve settlement fails. Furthermore, such economic distortions would mean that a pass-on mechanism would not work.

[11] ICMA also notes the ECB's opinion that *'it would be preferable to discard the possibility of mandatory buy-ins altogether'*

symmetry for cash compensation). ICMA would further propose that in the vent that MBIs are applied to a particular market, this could more effectively achieved through market regulation, rather than post-trade regulation.

In addition to penalties, and as an alternative to MBIs, ICMA would also point to other potential measures to improve settlement efficiency as part of the two-step approach. This could include (but not be limited to) delegated regulatory interventions in support of current market initiatives to establish market best practice around shaping, partialing, and the use of auto-borrow/lending programs. The availability of contractual buy-in processes, or similar remedies for settlement fails, in markets where relevant could be a further consideration.

As a helpful note of reference, we would point to recent industry initiatives to improve settlement efficiency, including the work undertaken by ICMA on *Optimising Settlement Efficiency*,[12] and related best practice recommendations which was originally focused on the EU repo market but has since been extended to international bond markets.[13]

[12] See: https://www.icmagroup.org/assets/Uploads/ERCC-discussion-paper-on-settlement-efficiency.pdf?vid=2&showiframe=true

[13] https://www.icmagroup.org/News/news-in-brief/icma-publishes-market-best-practice-recommendations-to-support-settlement-efficiency-in-the-secondary-bond-markets/

Annex 1: proposed drafting amendment for a more flexible two-step approach

Article 7(2)

(b) the following paragraph 2a is inserted:

‘2a. Without prejudice to the penalty mechanism referred to in paragraph 2 of this Article and the right to bilaterally cancel the transaction, the Commission may, by means of an implementing act, decide to which of the financial instruments referred to in Article 5(1) or categories of transactions in those financial instruments the settlement discipline measures referred to in paragraphs 3 to 8 of this Article are to be applied where the Commission considers that those measures constitute a proportionate means to address the level of settlement fails in the Union and that, based on the number and volume of settlement fails, ~~any of~~ the following conditions ~~is~~ are met:

(a) the application of the cash penalty mechanism referred to in paragraph 2 has not resulted in a long-term, continuous reduction of settlement fails in the Union, even following a recalibration of the applicable penalty fee(s) and/or other interventions to improve settlement efficiency;

(b) settlement efficiency in the Union has not reached appropriate levels considering the situation in third-country capital markets that are comparable in terms of size, liquidity as well as instruments traded and types of transactions executed on such markets, while taking into account differences in market structure and methodologies for recording settlement fails;

(c) the level of settlement fails in the Union has or is likely to have a negative effect on the financial stability of the Union.

The implementing act shall be adopted in accordance with the examination procedure referred to in Article 68(2).’, with full transparency of the assessment process and sufficient time to allow for market adoption;

Annex 2: proposed drafting amendment to remove SFTs from scope of MBIs

Article 7(4)

(e) paragraph 4 is replaced by the following:

(a) based on asset type and liquidity of the financial instruments concerned, the extension period may be increased from 4 business days up to a maximum of 7 business days where a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned;

(b) for operations composed of several transactions ~~including securities repurchase or lending agreements,~~ the buy-in process referred to in paragraph 3 shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective;

(c) for settlement fails that occurred for reasons not attributable to the participants, the buy-in process referred to in paragraph 3 shall not apply;

(d) for transactions that do not involve two trading parties the buy-in process referred to in paragraph 3 shall not apply;

(e) for documented securities financing transactions, the buy-in process referred to in paragraph 3 shall not apply;

Annex 3: proposed drafting amendment to achieve symmetry in cash compensation payment

Article 7

7. If the buy-in fails or is not possible, the receiving participant can choose to be paid cash compensation or to defer the execution of the buy-in to an appropriate later date ('deferral period'). If the relevant financial instruments are not delivered to the receiving participant at the end of the deferral period, cash compensation shall be paid.

Cash compensation shall be paid to the receiving participant no later than on the second business day after the end of either the buy-in process referred to in paragraph 3 or the deferral period, where the deferral period was chosen.

Be replaced by the following:

7. If the buy-in is not possible, the receiving participant can choose an alternative of cash compensation or to defer the execution of the buy-in to an appropriate later date ('deferral period'). If the relevant financial instruments are not delivered to the receiving participant at the end of the deferral period, cash compensation shall be paid.

Where the price of the financial instruments agreed at the time of the trade is different from the price used to determine cash compensation, the corresponding difference shall be paid by the participant benefitting from such price difference to the other participant no later than on the second business day after the end of either the buy-in process referred to in paragraph 3 or the deferral period, where the deferral period was chosen.

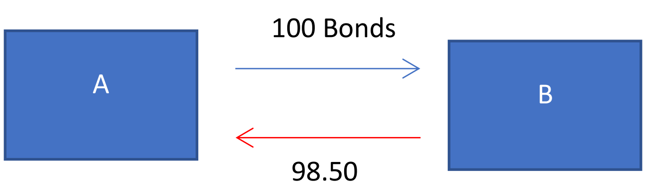
Annex 4: market buy-ins

A market buy-in is a contractual remedy available to a purchasing counterparty of financial securities in the event that the selling counterparty fails to deliver the securities[14]. Where the selling counterparty fails to deliver on the agreed settlement date, the purchasing counterparty has the right to enforce delivery by instructing a third-party (a buy-in agent) to purchase and deliver the securities to replace the original transaction. Any differences between the price of the original transaction and the buy-in price are settled between the selling and purchasing counterparty. The purpose and effect of the buy-in process is to return all counterparties to the economic position they would have been in had the original transaction settled on the intended settlement date.

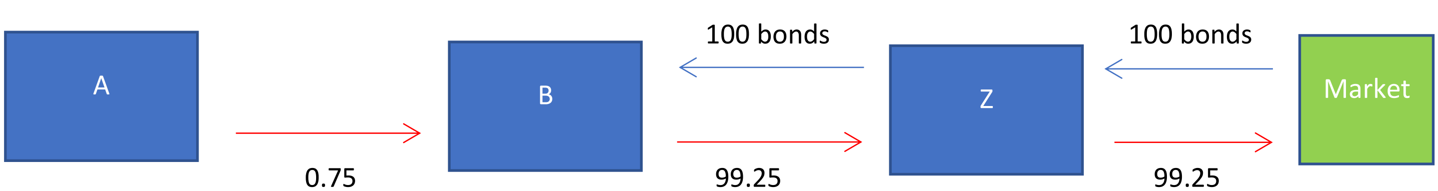
<u>Example of the buy-in process</u>

Counterparty A sells 100 bonds to counterparty B at price of 98.50.
The trade does not settle, and B elects to initiate a buy-in against A.
The buy-in agent (Z) purchases the bonds at a price of 99.25 and delivers them to B at the same price (99.25).
Simultaneously, B cancels the original settlement instruction with A.
A pays B the difference between the original transaction and the buy-in price, i.e. 0.75.
If A now re-sells (or marks-to-market) their original 100 bonds (at the market price of 99.25), both A and B will be in the same economic position they would have been in had the transaction settled.

The original transaction



The buy-in



The above diagram shows clearly how the buy-in restores the economic position of A and B. B receives the securities at the equivalent price of the initial transaction (99.25-0.75), and A, after re-

[14] It should be noted that in some instances the fail is caused by the purchaser, and not the seller, in which case the equivalent remedy is a 'sell out'. (CSDR does not provide a requirement or provisions for sell-outs.)

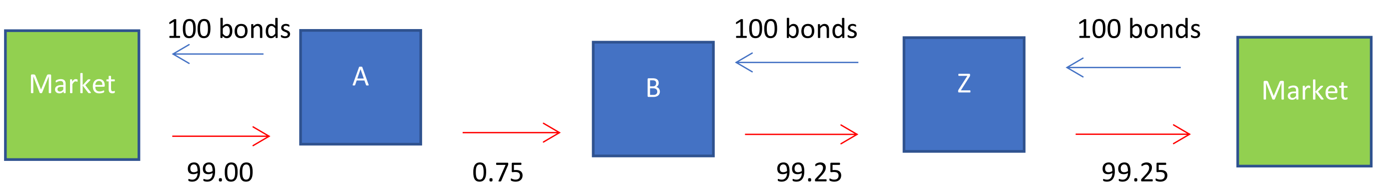
selling/marking their position at the new market price of 99.25,[15], is economically in the same position as if the original trade had settled at 98.50 (99.25-0.75).

<u>The costs arising from a buy-in</u>

A buy-in is not intended to penalise a failing counterparty, nor is it the appropriate legal construct to attempt this. A buy-in is a contractual remedy designed to restore the trading counterparties to the economic position they would have been in had the original transaction settled. However, the failing counterparty being bought-in will invariably suffer some economic cost through the process. This is as a consequence of the buy-in execution price being higher than the market 'fair value' price. The reason for this difference is that a buy-in will be for *guaranteed delivery*, which means that the seller into the buy-in must physically hold the securities and be able to deliver them to the buy-in agent; this invariably commands a premium. Furthermore, a buy-in in itself is a signal to the market that securities will be purchased *no matter what the price*, and so sellers will adjust their offer prices accordingly. As a general rule, the less liquid the security, the greater the *buy-in premium*.

The cost of the buy-in premium to the failing counterparty is illustrated below, drawing on the same example used above.

The cost to the failing counterparty due to the buy-in premium



In this scenario the buy-in is executed at 99.25, compared to a 'fair' market price of 99.00. B is restored to its original position of buying the securities at an equivalent of 98.50 (99.25 – 0.75), however, when A re-sells/marks its position, it incurs a loss of 0.25 (99.00 – 98.50 – 0.75).

It should also be remembered that even where the buy-in execution price is the same as the market price, the counterparty being bought-in will most likely still incur a cost through the bid-ask spread (with the buy-in executed at the 'ask' price, and the bought-in counterparty re-selling/marking their position at 'bid'). Furthermore, the bought-in counterparty may be liable for any fees charged by the buy-in agent (see earlier section).

[15] It is important to understand that after the selling counterparty (A) is bought-in, the original settlement instruction is canceled which restores A to the position they were in before the original transaction. The new position will either need to be flattened (through another sale) or marked-to-market; either of which (after the price differential between the buy-in price and the original transaction price is settled between A and B) will restore A to the economic position they would have been in had the original trade settled.

Annex 5: the differences between market buy-ins and CSDR buy-ins

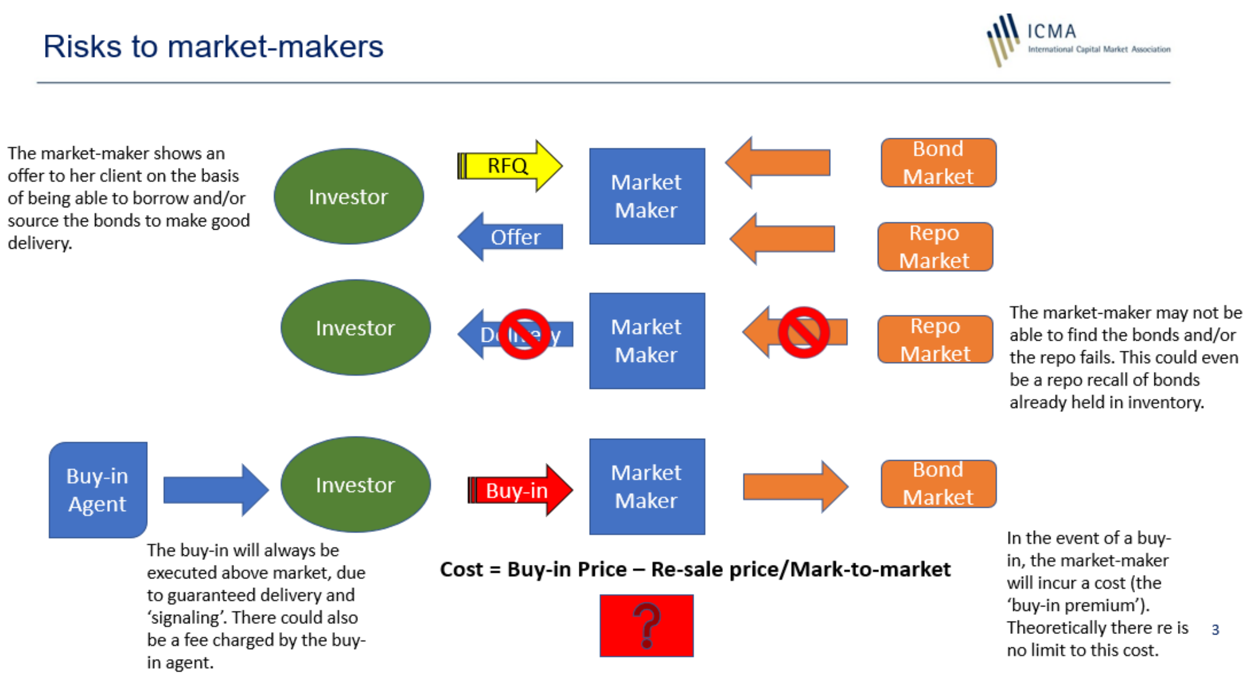
Note that this is based on the regulatory buy-ins as currently in law and does not take account of the revisions in the European Commission's proposal

ICMA Buy-in Rules	CSDR
Discretionary: can be initiated at any time from ISD+1	Mandatory: must be initiated on ISD+4 (liquid equities) or ISD+7
Non-defaulting party can elect time between notification and date of buy-in (4 to 10 days)	Non-defaulting party must start buy-in process following the extension period
Buy-in process can run indefinitely	Buy-in must be completed in 4 or 7 days, with option to attempt ('defer') for one more attempt
No requirement to appoint a buy-in agent	Requirement to appoint a buy-in agent
Buy-in differential (buy-in price vs original price) is paid in either direction between seller and buyer depending on which is higher/lower.	Buy-in differential payment is asymmetrical, and is only paid by the seller to the buyer where the buy-in price is higher. Where it is lower, the differential is "deemed paid".
Buy-in is for guaranteed delivery (buy-in is complete on execution). This minimises risk for all parties.	No guaranteed delivery: buy-in is complete only on successful settlement
Cash compensation is possible, but not prescribed.	Cash compensation is prescribed.
Pass-on mechanism to provide for single buy-in to settle settlement chains	No pass-on mechanism
Applies to all firms trading under ICMA Rules (usually members) in 'international securities'. The ICMA Rules form part of the contractual trading agreements between member firms.	Applies to all transactions intended to settle on an EU/EEA CSD in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances, which are admitted to trading or traded on a trading venue or cleared by a CCP.

Annex 6: market-making and the impacts of MBIs on pricing and liquidity

As part of their role as liquidity providers, market-makers are often required to provide offers in securities that they do not hold on their books. For bonds, this is generally expected to be the case for around 20-25% of all sales. The market-maker will then look to obtain the securities, usually in the first instance in the repo market[16], and then later to buy them back outright in the market. Market-makers generally do not look to run short positions for very long, given capital costs and risk limits, and will try to buy back the securities as quickly as possible. In most cases they will successfully do so. In a few cases, however, they may struggle either to buy back the bonds or to source them in the repo market, leading to a settlement fail.

In these cases, the purchasing party, usually an investor, will have the discretionary right to issue a buy-in to enforce settlement (see Appendix 4). However, in most instances they may decide to accept and manage the resulting counterparty exposure and allow more time for the market-maker to source the bonds. This also provides the market-maker with more confidence to provide offer-side liquidity.
In the case of a buy-in, market-makers will incur costs, sometimes significant, which could affect their ability to provide liquidity in the future. This risk is illustrated below.



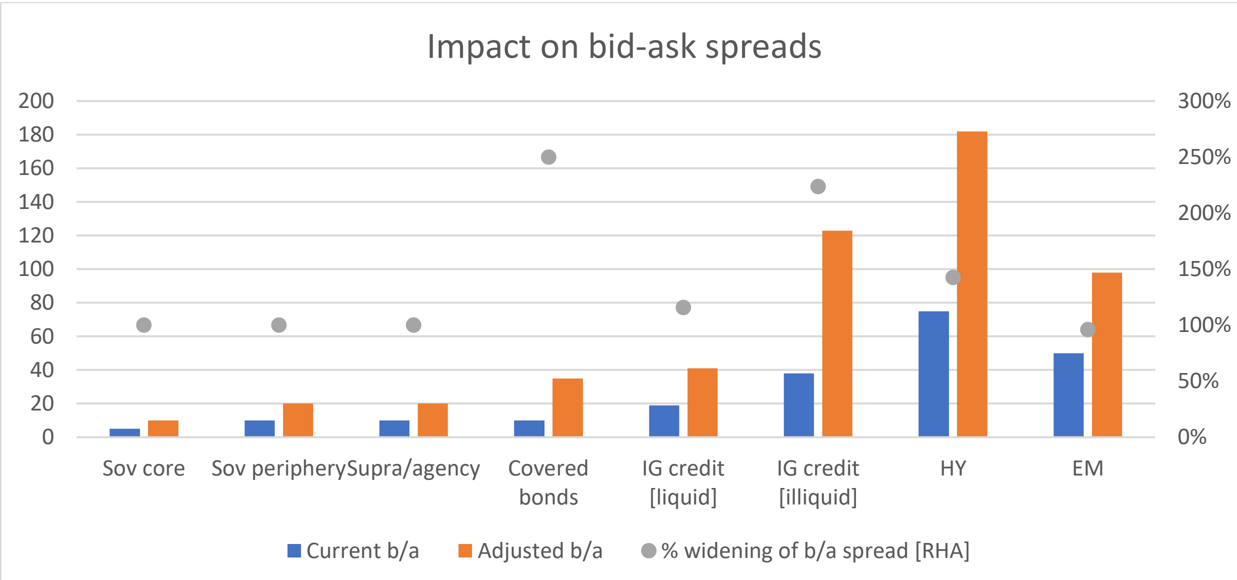
When the risk of a buy-in increases, market-makers naturally adjust for their assessment of this risk, either by adjusting their pricing (so a direct cost to investors) or by declining to show a price (so a loss of liquidity for the investor). Given that the CSDR MBI requirement will increase the probability of buy-ins being executed in the case of settlement fails, the risks to market-makers also increase when showing offers to clients. These impacts are estimated in a 2019 impact study[17] undertaken by ICMA and are

[16] https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/icma-ercc-publications/frequently-asked-questions-on-repo/1-what-is-a-repo/

[17] See: https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/CSDR-Settlement-Regulation/Mandatory-buy-ins-under-CSDR-and-the-European-bond-markets-Impact-Study-271119.pdf

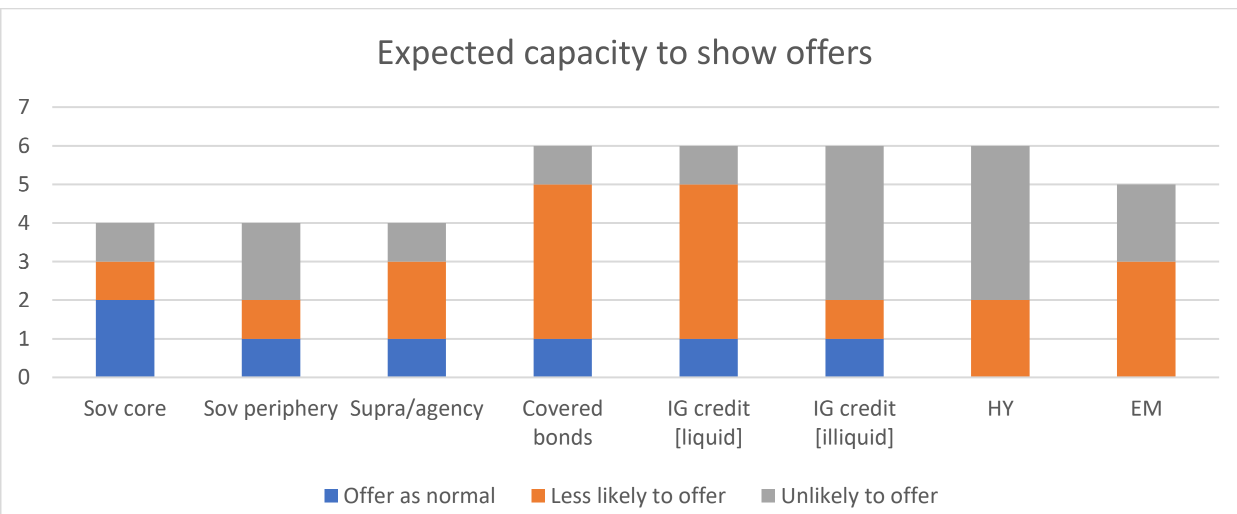
illustrated below. Not surprisingly, bid-offer spreads widen significantly, particularly in the case of less liquid bond segments, such as corporates and non-core sovereigns. Similarly, the propensity to show offers also decreases with liquidity.

Change in market-making bid-offer for bonds not held in inventory (post CSDR MBI)



Source: ICMA impact study (2019)

Expected capacity to show offers in bonds not held in inventory (post CSDR MBI)



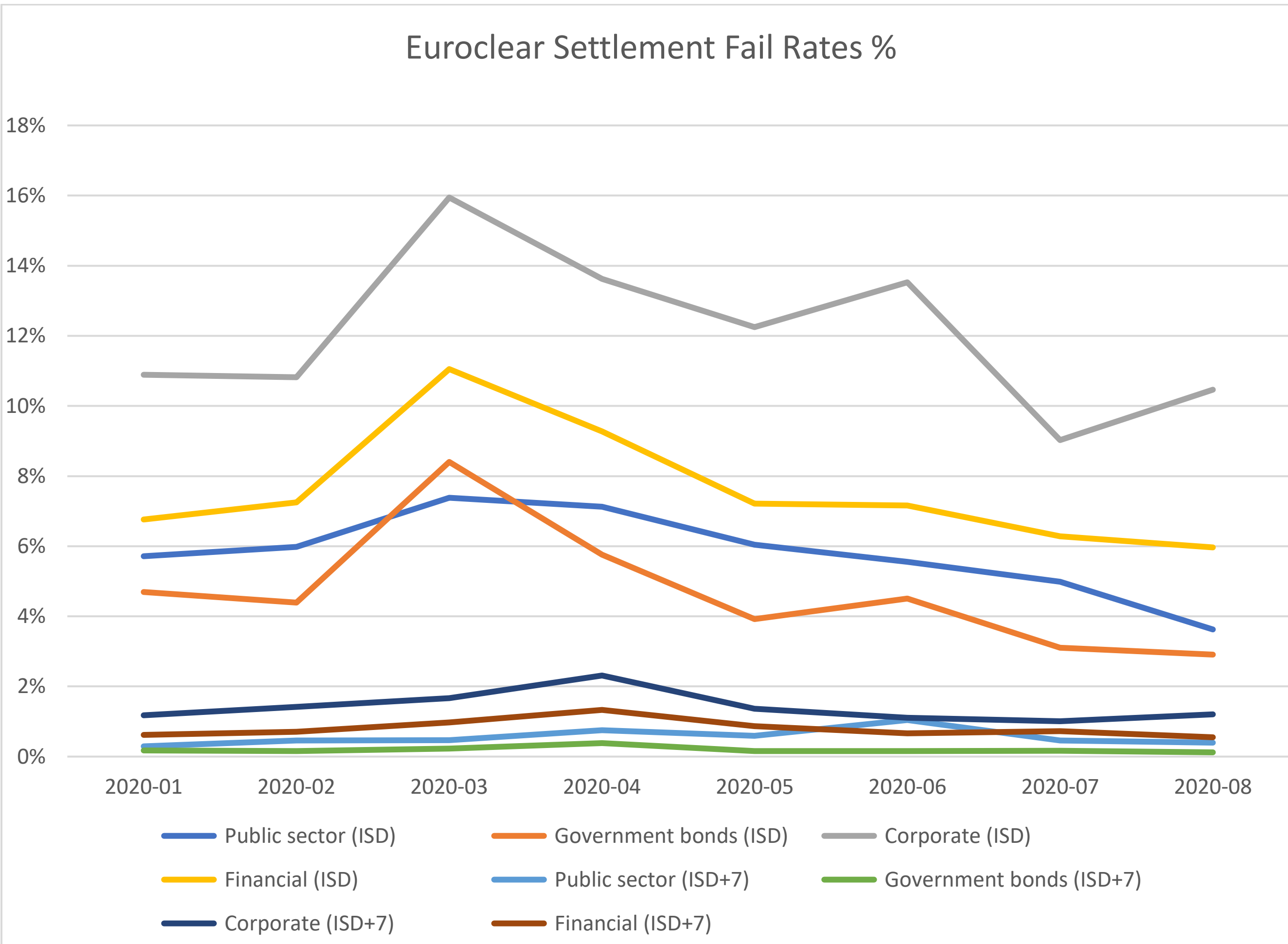
Source: ICMA impact study (2019)

Annex 7: settlement rates, expected buy-ins, and impact of Covid-19

Settlement efficiency rates in the European bond markets are generally considered to be quite high (certainly relative to equities and ETFs), although there is still room for improvement.

The below shows settlement efficiency rates, provided by Euroclear, for bonds over the period January-August 2020. The data shows rates both on Intended Settlement Date (ISD) and ISD+7, when the mandatory buy-in for bonds would be triggered. It can be seen that rates improve significantly between ISD and ISD+7 (e.g. on average from 95.3% to 99.8% for government bonds and from 87.9% to 98.6% for corporate bonds).

Euroclear settlement fail rates for bonds (Jan-Aug 2020)

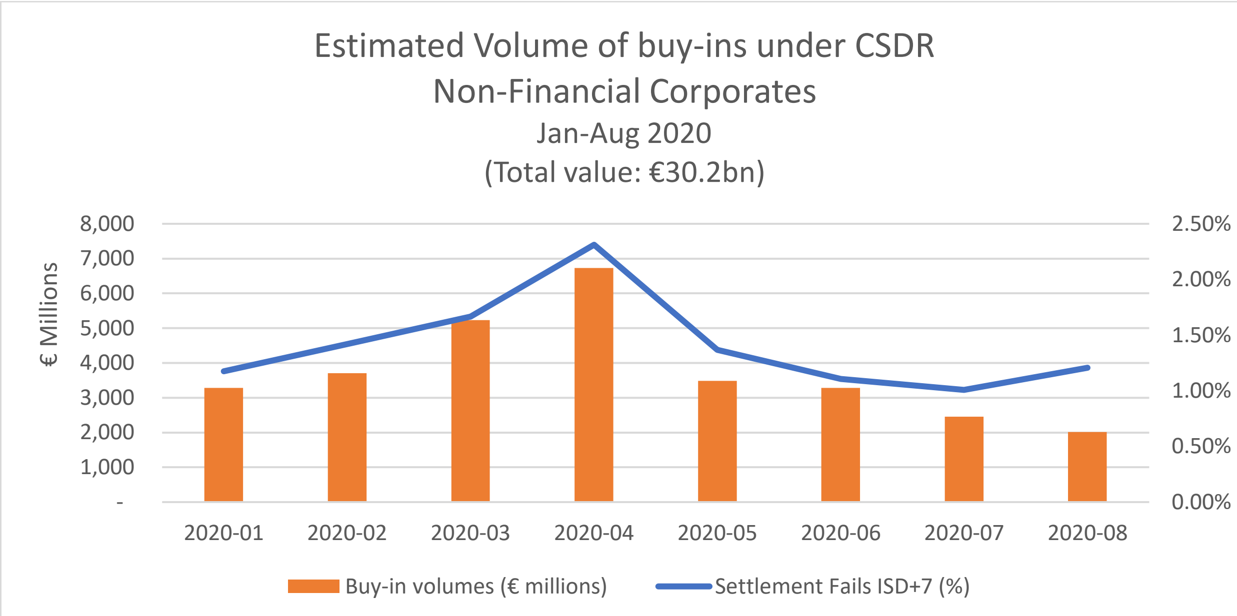


Source: ICMA analysis using Euroclear Bank data

While the percentage of settlement fails at ISD+7 is relatively low, in absolute terms this would trigger a significant volume of buy-ins. This is illustrated below by applying the Euroclear settlement efficiency rates on ISD+7 to total market volumes (using Bloomberg MiFID II/R data). As can be seen, the projected numbers run into many billions of euros.

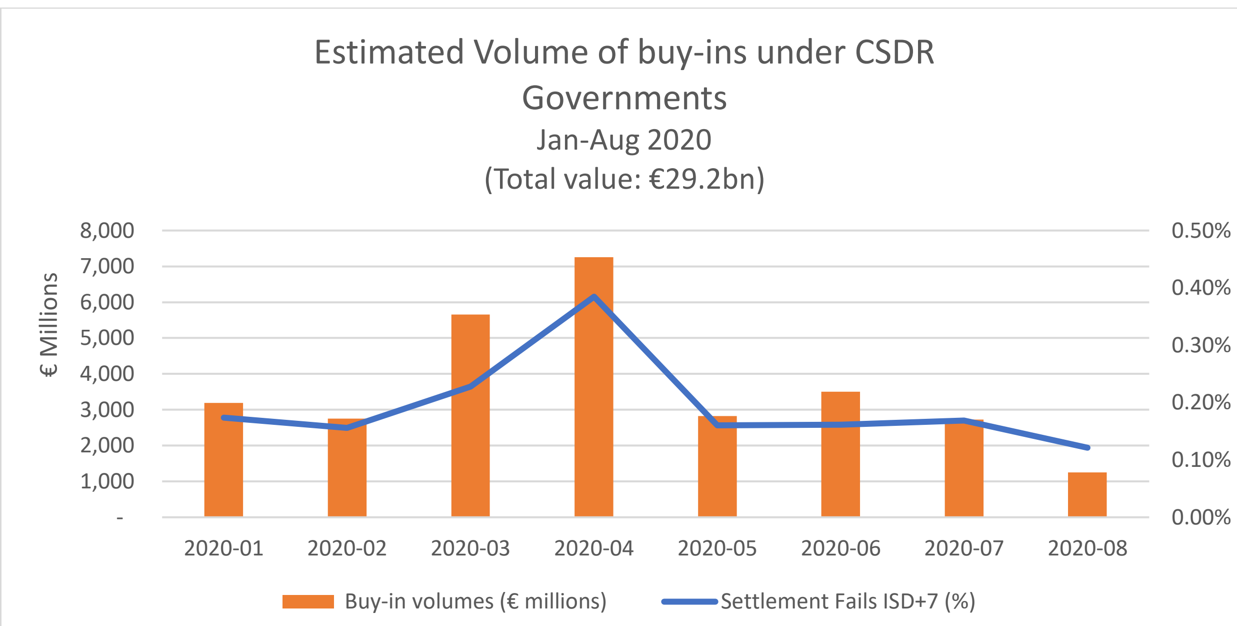
It can also be seen that these volumes would have increased dramatically during the March-April covid turmoil, when settlement fails increased sharply for technical reasons related to back- and middle offices transitioning to working remotely. This would also have been at a time when bond markets were at their most volatile and least liquid, raising concerns of procyclical risks

Estimated buy-in volumes for corporate bonds under CSDR MBI (Jan-Aug 2020)



Source: ICMA analysis using Euroclear Bank and Bloomberg data

Estimated buy-in volumes for government bonds under CSDR MBI (Jan-Aug 2020)



Source: ICMA analysis using Euroclear Bank and Bloomberg da

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