CSDR Mandatory Buy-ins & Repo

ERCC update

April 2020
Outline

- What is CSDR, Settlement Discipline, the mandatory buy-in regime, and its scope?
- What are the challenges for firms caught under the buy-in regime, and what are ICMA and others doing about it?
- What are the potential implications for repo market functioning and liquidity?
Outline

- What is CSDR, Settlement Discipline, the mandatory buy-in regime, and its scope?
What is CSD Regulation & CSDR Settlement Discipline?

- CSD Regulation (CSDR) is an EU regulation which introduces measures for the authorization and regulation of EU central securities depositories (CSDs).
- While much of the regulation focuses on the prudential, organizational, and business standards of CSDs, some of its requirements directly affect trading level entities that settle trades on EU CSDs. This includes measures to address settlement fails.
- Chapter III of the Regulation deals with Settlement Discipline. Article 7 provides for measures to address settlement fails, which includes cash penalties for settlement fails and mandatory buy-ins.
- CSDR entered into force in September 2014.
- The Settlement Discipline measures (including mandatory buy-ins) were due to come into force from September 2020, but ESMA has now submitted amended RTS with an implementation date of February 1 2021.*

* This delay is purely technical, and largely due to the timing of the SWIFT messaging roll-out required to support the implementation of cash penalties in T2S.
What is the scope of CSDR Settlement Discipline?

- Settlement Discipline will apply to all transactions intended to settle on an EU CSD\(^1\) in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances,\(^2\) which are admitted to trading or traded on a trading venue or cleared by a CCP.\(^3\)

- This will apply to all trading level entities regardless of their domicile, that enter into such transactions that settle on an EU CSD, whether directly as CSD members, or indirectly via a settlement or clearing agent (a “CSD participant”).

- It is important to note that initiating the CSDR buy-in process is a regulatory requirement and not a right.

- Securities financing transactions (SFTs) are in scope of settlement discipline.\(^4\)

- SFTs with terms ≤ 30 business days are out of scope of mandatory buy-ins.\(^5\)

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1 Articles 1(1) and 1(2)
2 Article 5(1)
3 Article 7(10)
4 Article 7(4)(b)
5 RTS: Article 22(2)
What is a CSDR mandatory buy-in?

- Executed at **trading level** (similar to conventional buy-in mechanisms).
- For non-centrally cleared trades, requires the appointment of a buy-in agent.
- Buy-in process is automatically triggered 4 business days after intended settlement date (ISD) for liquid\(^1\) equities, and **7 business days** after ISD for all other instruments, including bonds (called the “extension period”).
- Buy-in must be completed (settled) within 4 business days\(^1\) for liquid equities, and 7 business days for all other instruments.
- If buy-in is not possible, the non-defaulting party can initiate one more attempt (the “deferral period”). Otherwise the buy-in will result in “cash compensation”.
- The payment of the buy-in / cash compensation is asymmetrical and can only be paid in one direction.

\(^1\) As determined by Article 4(6)(b) of Regulation (EU) No 600/2014 (MiFIR)
Outline

- What are the challenges for firms caught under the buy-in regime, and what are ICMA and others doing about it?
Challenges

- Scope and application
  - Certain SFTs (open, basket trades)?
  - How to buy-in an SFT?
  - Margin/collateral movements?
  - Finding a buy-in agent?
  - Pass-ons / multiple buy-ins?
  - Establishing the appropriate reference price ("market value") for cash compensation?
  - Dispute resolution?

- Enforceability
  - Contractual arrangements (Article 25)?
  - Extraterritorial application?
  - Monitoring and sanctions?

- Impacts for market liquidity
  - Bond markets?
  - Repo and securities lending markets?
What is ICMA doing about CSDR buy-ins?

- Updating the GMRA to cover in-scope SFTs*
- Working with ISLA to establish **best practice for SFTs** in the case of fails
- In March 2020, published FAQs on CSDR mandatory buy-ins and Securities Financing Transactions. The FAQs are intended to outline considerations and, where possible, to provide clarity with respect to the application of CSDR buy-ins in the case of repos and other SFTs. The FAQs will be updated in light of new guidance from ESMA and agreed market best practice.
- Working with ISLA to propose appropriate **exemptions for certain SFTs:**
  - In February 2020, ICMA and ISLA, on behalf of the European repo and securities lending community, submitted a Q&A to ESMA requesting Level 3 guidance that open, and open-like, SFTs should be exempted from the CSDR buy-in requirements based on their earliest contractual termination date. This is in line with other regulatory treatments (e.g. for LCR and NSFR purposes) as well as general accounting practice. The results of a survey of ERCC and ISLA members on their treatment of open SFTs was also shared with ESMA.
  - ICMA, jointly with ISLA, plans to submit Q&As requesting an exemption for certain basket trades (triparty and DBV).

* ICMA has created a CSDR Legal Workstream to facilitate the necessary contractual revisions for cash and SFTs
What is ICMA doing about CSDR buy-ins?

- Updating the **ICMA buy-in rules** to be CSDR compliant:* 
  - Providing a contractual framework and market best practice to support implementation 
  - Providing contractual solutions to some of the regulation’s more problematic challenges

- **Addressing the asymmetric payment provisions** for buy-in and cash compensation
  - Working with ESMA to provide Q&A that allows for symmetrical payments through contractual agreements (such as the ICMA buy-in rules)

- In March 2020, ICMA submitted Q&As to ESMA outlining the cross-industry buy-in pass-on mechanism to enhance the CSDR buy-in process. The submission is in the form of two separate Q&As: (i) a pass-on mechanism between failing transactions with the same intended settlement date; and (ii) a pass-on mechanism between failing transactions that may have different intended settlement dates. These proposals were developed as a cross-industry effort, led by ICMA and AFME, and are based on existing mechanisms widely used in the non-cleared markets (such as under the ICMA Buy-in Rules).

- ICMA has created a workstream to explore possible best practice for establishing the appropriate reference price in the case of cash compensation.

* ICMA has created a CSDR Legal Workstream to facilitate the necessary contractual revisions for cash and SFTs
What is ICMA doing about CSDR buy-ins?

Advocacy

- Raising awareness of scope, details, and potential implications.
  - In particular non-EU entities and smaller buy-sides

- Continuing advocacy with regulators and policy makers with a view to delaying/amending the CSDR mandatory buy-in provisions.
  - ICMA’s position is that cash penalties should be made more punitive as a less disruptive alternative to applying the mandatory buy-in regime
  - ICMA undertook a 2nd Bond Market Impact Study in fall 2019 (following the previous study of 2015)
  - In January 2020, ICMA joined a cross-industry initiatives to request that the European Commission and co-legislators consider deferring implementation of the buy-in regime (until an assessment of the impact of penalties, as well as a detailed, quantitative analysis of potential impacts of the regime).
  - ICMA’s Asset Management and Investors Council (AMIC) is also working with other buy-side associations, including the IA and EFAMA, to raise the concerns of the European and international asset management industry.

Potential for delay due to Covid-19 crisis?
Outline

- What are the potential implications for repo market functioning and liquidity?
ICMA Bond Market Impact Study (2019)

- Follows up on ICMA’s 2015 Bond Market Impact Study

- Study sets out to answer five questions with respect to the CSDR mandatory buy-in regime:
  1. What is the general preparedness of firms both from an operational and trading strategy perspective?
  2. How will sell-sides adjust their pricing and liquidity provision across a range of bond sub-classes?
  3. What are the expectations of buy-sides with respect to pricing and market liquidity?
  4. What are the likely impacts for repo and securities lending?
  5. What possible refinements or enhancement to the framework could help to mitigate the risks of unintended consequences?

- Methodology
  - Survey based with three survey templates: sell-side, buy-side, repo and securities lending desks
  - 44 responses, representing buy-side firms (16), sell-side firms (16), and repo and securities lending desks (12).

- Focus is on euro bond markets, but impacts are expected to extend to all securities settled on EU (I)CSDs
Awareness and preparedness

Market awareness
- Broad awareness: 5%
- Limited awareness: 60%
- Very little awareness: 35%

Plans to adapt operational processes
- Yes: 70%
- No: 5%
- Not sure: 25%

Plans to adapt risk management and trading
- Yes: 60%
- No: 10%
- Not sure: 30%
ICMA: CSDR-SD mandatory buy-ins

**Repo and securities lending**

**Expected impact on lending securities**

- **Sov core**: 10%
- **Sov periphery**: 9%
- **Supra/agency**: 8%
- **Covered bonds**: 6%
- **IG credit (liquid)**: 5%
- **IG credit (margined)**: 4%
- **HY**: 3%
- **EM**: 2%

**Expected impact on SFT market efficiency and liquidity**

- **Improve**: 10%
- **Little or no impact**: 5%
- **Worsen**: 70%
- **Worsen significantly**: 10%
Resources

- March 2020: ICMA FAQs on CSDR mandatory buy-ins and SFTs
- November 2019: ICMA CSDR buy-in impact study for EU bond markets
- August 2019: ICMA information brochure on CSD Regulation mandatory buy-ins
- June 2018: How to survive in a mandatory buy-in world
- May 2017: ICMA Position Paper on CSDR Settlement Discipline
