CSDR Mandatory Buy-ins & SFTs

ICMA ERCC Professional Repo Market & Collateral Management Workshop

5 October 2021

CSDR mandatory buy-ins & SFTs

Agenda

1. What is a buy-in and how does it work?
2. What is a mini close-out and how do they work? (Refresher)
3. CSDR mandatory buy-ins
4. Considerations for in-scope SFTs
5. Considerations for out-of-scope SFTs
6. ICMA Impact study
7. Current state of play

CSDR mandatory buy-ins & SFTs

1. What is a buy-in and how does it work?

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What is a buy-in?

- Buy-ins generally apply to failing cash transactions and not to SFTs.
- In the event of a settlement fail, a buy-in mechanisms provide a buyer of securities the contractual right to source the securities elsewhere (usually for guaranteed delivery), cancel the original trade, and settle between the two original counterparties any differences arising from the net costs of the original transaction and the buy-in transaction.
- A key feature of conventional buy-ins (such as the ICMA Buy-in Rules, used in the cross-border non-cleared bond markets) is that the economics of the original transaction are preserved, and that neither party is inadvertently disadvantaged or advantaged as a result of the buy-in.
- Standard buy-ins are not a ‘penalty mechanism’, they are a contractual remedy to provide for physical settlement of a trade.
- They are also executed at the discretion of the failed-to (non-defaulting) entity, as a right and not an obligation.
- Traditionally the buy-in is executed by a buy-in agent: and independent 3rd party appointed by the non-defaulting party (although this requirement was recently removed from the ICMA Buy-in Rules).
- A ‘pass-on’ mechanism allows for a single buy-in to be passed along a chain of linked failing transactions.

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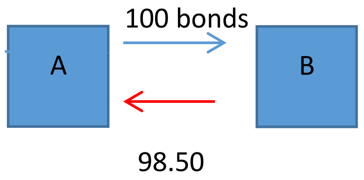
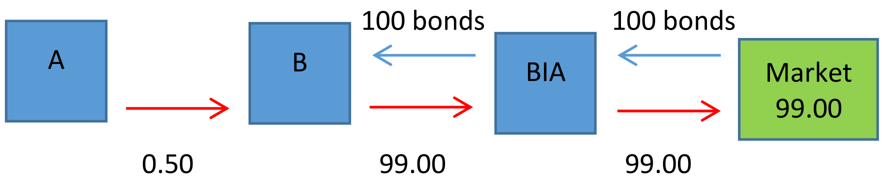
How do buy-ins work?

Original trade

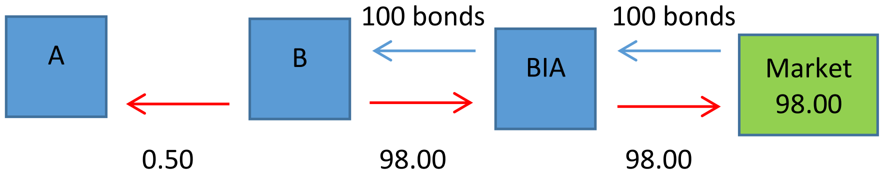


Buy-in at a higher price



	A	B
P&L before buy-in	(0.50)	+0.50
P&L after buy-in	(0.50)	+0.50
P&L impact of buy-in	0	0

Buy-in at a lower price



	A	B
P&L before buy-in	+0.50	(0.50)
P&L after buy-in	0.50	(0.50)
P&L impact of buy-in	0	0

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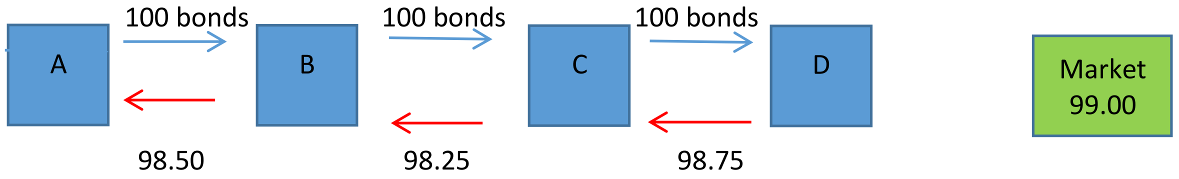
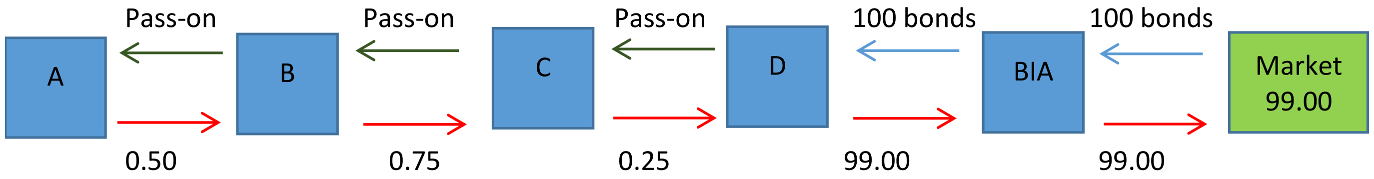
How do 'pass-ons' work?

A 'pass-on' mechanism allows each party in the transaction chain to pass-on a buy-in notification to the party failing to them, until it reaches the original fail. A single buy-in is executed by the initiating party, and the cash differentials between each original transaction and the buy-in price is settled between each of the parties in the chain.

Original trade

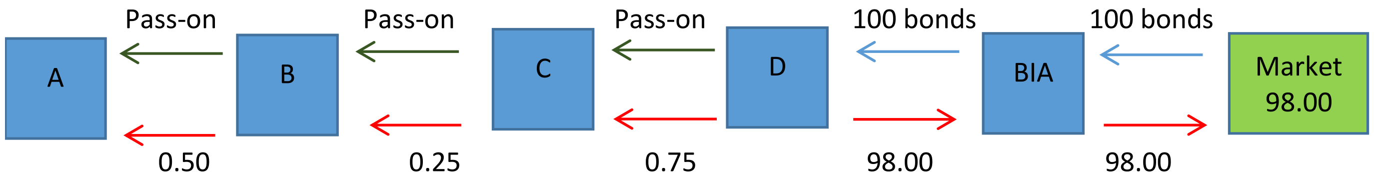


Buy-in with pass-on



	A	B	C	D
P&L before buy-in	(0.50)	(0.25)	+0.50	+0.25
P&L after buy-in	(0.50)	(0.25)	+0.50	+0.25
P&L impact of buy-in	0	0	0	0

Buy-in with pass-on (lower price)



	A	B	C	D
P&L before buy-in	0	(0.25)	+0.50	(0.25)
P&L after buy-in	0	(0.25)	+0.50	(0.25)
P&L impact of buy-in	0	0	0	0

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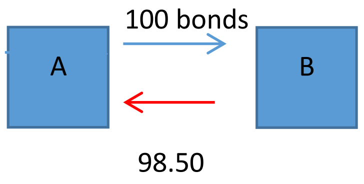
Is there a cost to the party being bought-in?

Original trade

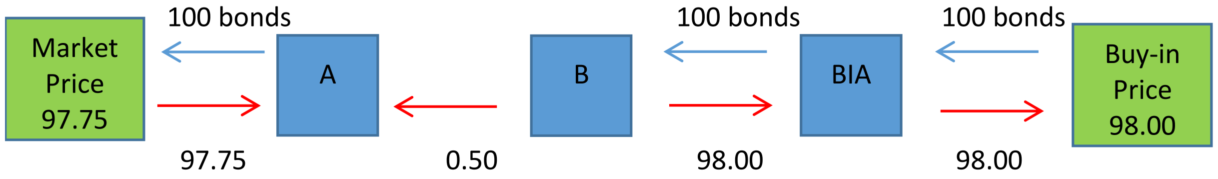


Generally, the bought-in counterparty will incur a cost as a result of the buy-in. This is the result of the buy-in price being higher than the prevailing market price. The difference between the buy-in price and current market price is known as the 'buy-in premium').

Usually buy-in prices are higher than the prevailing market price due to a premium for 'guaranteed delivery'. But it can also be due to costs/spreads added by the buy-in agent, and also as a result of a market signaling mechanism with a 'stressed buyer' in the market.

Importantly, these costs have nothing to do with the original transaction price.

Post buy-in



	A	B
P&L before buy-in	+0.75	(0.75)
P&L after buy-in	+0.50	(0.75)
P&L impact of buy-in	(0.25)	0

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2. What is a mini close-out and how do they work? (Refresher)

CSDR mandatory buy-ins & SFTs

What happens if a party fails to deliver collateral on the start-leg of an SFT?

In the event of a failure by a seller to deliver collateral to the buyer at the start of a repo, if the parties have signed a GMRA,[1] one of the following will happen:

- If the parties have agreed, when they negotiated their agreement, to treat a failure to deliver collateral as an event of default, the buyer could place the seller in default. However, putting a counterparty into default is a very serious step. It is important to be sure that her failure to deliver reflects credit problems and not temporary operational problems, infrastructure frictions or market illiquidity, which are all beyond the seller's control.
- The contract remains in force but the buyer withholds cash from the seller. This option allows the seller to deliver the collateral at any time during the remaining life of the contract. Only if and when delivery eventually takes places will the buyer pay the seller. But whether or not the seller ever delivers the collateral, at the end of the repo, the seller will be obliged to pay to the buyer the repo interest for the full intended term of the transaction. This means that the seller is penalised for failing to deliver and the buyer is compensated.
- The buyer terminates the failed transaction (he can do this at any time). If she does, the seller will be obliged to pay whatever repo interest has accrued up to the date of termination.

[1] GMSLA provisions are broadly similar

CSDR mandatory buy-ins & SFTs

What happens if a party fails to deliver collateral on the end-leg of an SFT?

In the event of a failure by a seller to deliver collateral to the buyer at the start of a repo, if the parties have signed a GMRA,[1] one of the following will happen:

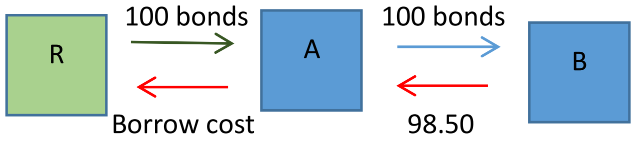
▪If the parties have agreed, when they negotiated their agreement, to treat a failure to deliver collateral as an event of default, the seller could place the buyer in default.
▪The seller could call a ***mini close-out***, which means he terminates the failed transaction (but no others), values the collateral in that transaction using the methodology set out in the GMRA for defaults, offsets this against the cash she owes the buyer and settles any difference. However, mini close-outs can prove to be very expensive for parties failing to deliver. In repo markets, such as those for government bonds, which trade at narrow spreads, it is felt that the threat of mini close-outs would drive many banks out of the market and fatally damage its liquidity, so mini close-outs are in practice restricted to fails in types of collateral such as corporate bonds. Note that the mini close-out mechanism works differently from the 'buy-in' procedure used in the cash market when the seller fails to deliver to the buyer in an outright transaction.
▪The parties could negotiate a solution. Until then, the repo would continue, with the seller holding cash which will be interest-free after the repurchase date.

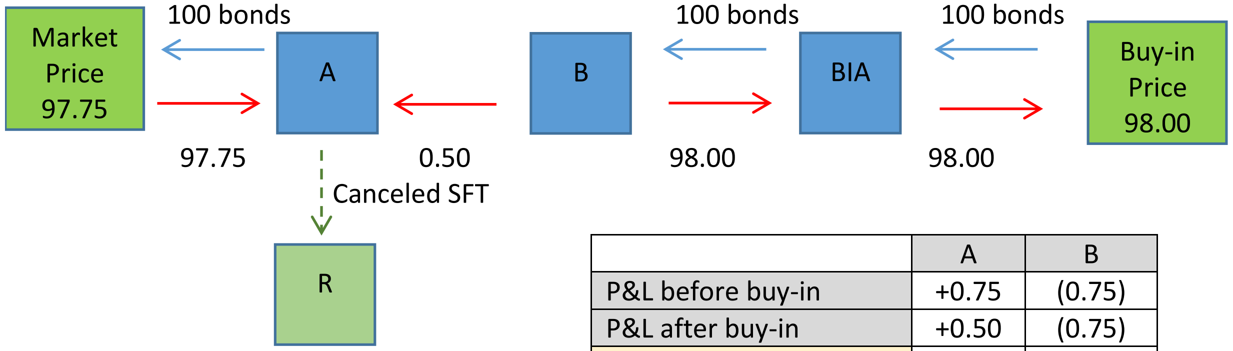
[1] GMSLA provisions are broadly similar

CSDR mandatory buy-ins & SFTs

The link between SFTs and cash trades: failing start-legs

Securities financing transactions (SFTs) are an integral component of liquidity provision in securities markets. As market-makers cannot realistically hold inventory in every security for which they make markets, in most instances they will need the ability to sell short in order to provide offers to clients. To do this, they will need to borrow the underlying security, which they do in the repo or securities lending markets.
If the SFT start-leg fails, the cash sale will fail, with the risk of a buy-in. The seller will not be able to pass any buy-in costs on to the failing repo counterparty.





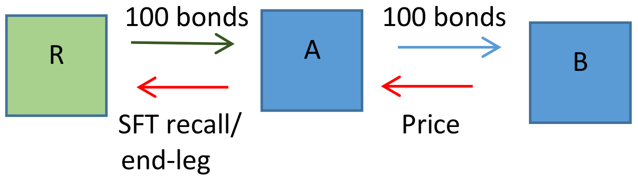
	A	B
P&L before buy-in	+0.75	(0.75)
P&L after buy-in	+0.50	(0.75)
P&L impact of buy-in	(0.25)	0

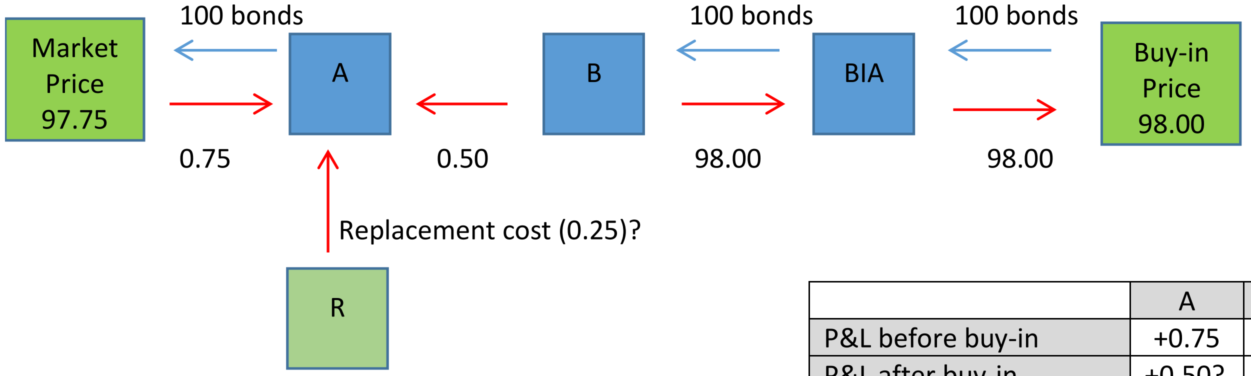
CSDR mandatory buy-ins & SFTs

The link between SFTs and cash trades: failing end-legs

Lenders of securities require the flexibility to recall the loan in the case of a sale. The risk is that the securities are not returned, which causes the onward sale to fail. This creates the risk of a buy-in.

While it is not possible to 'pass-on' a cash market buy-in under a GMRA/GMSLA, it may be possible to pass-on any buy-in costs through the mini close-out mechanism, since it could be argued that the buy-in cost is effectively the cost of replacing the securities. However, this could be challenged by the failing repo counterparty.





	A	B
P&L before buy-in	+0.75	(0.75)
P&L after buy-in	+0.50?	(0.75)
P&L impact of buy-in	(0.25)?	0

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3. CSDR mandatory buy-ins

CSDR mandatory buy-ins & SFTs

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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 mandatory buy-ins & SFTs

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 in scope of mandatory buy-ins. [5]

[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)

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When does CSDR Settlement Discipline come into force?

- CSDR was passed into law in August 2014.
- The draft RTS for mandatory buy-ins were submitted by ESMA in February 2016 and adopted by the European Commission in May 2018.
- Following a three-month period for scrutiny by the European Parliament and EU Council, the RTS was published in the EU Official Journal in September 2018.
- The go live date for settlement discipline has been delayed a number of times but is currently scheduled for **February 1 2022**.

CSDR mandatory buy-ins & SFTs

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”.
- There is no guaranteed delivery of the buy-in, which is only considered completed on settlement.
- A buy-in agent (with no ‘conflicts of interest’) must be appointed to execute the buy-in.
- SFTs with terms > 30 business days are in scope.
- 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)

CSDR mandatory buy-ins & SFTs

Key differences between ICMA Buy-in Rules and CSDR mandatory buy-ins

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)	No 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)	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.

[1] Defined as a security intended to be traded on an international, cross-border basis (ie between parties in different countries), and capable of settlement through an international central securities depository or equivalent.

CSDR mandatory buy-ins & SFTs

The CSDR mandatory buy-in asymmetry

Level 1: Article 7(6)

Without prejudice to the penalty mechanism referred to in paragraph 2, where the price of the shares agreed at the time of the trade is higher * than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by the failing participant no later than on the second business day after the financial instruments have been delivered following the buy-in.

RTS: Article 35

Payment of the price difference

1. Where the price of financial instruments referred to in Article 5(1) of Regulation (EU) No 909/2014 agreed at the time of the trade is lower than the price effectively paid for those financial instruments pursuant to Articles 27(10), 29(10), and 31(10), the failing clearing members, failing trading venue members or failing trading parties shall pay the price difference to the CCP, receiving trading venue members or receiving trading parties, as applicable.
Where transactions are cleared by a CCP, the price difference referred to in the first subparagraph shall be collected from failing clearing members by the CCP and paid to the receiving clearing members.

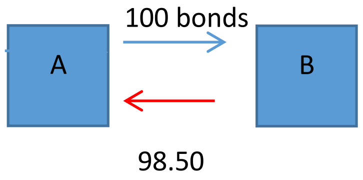
2. Where the price of the shares agreed at the time of the trade is higher than the price effectively paid for those shares pursuant to Article 27(10), Article 29(10) and Article 31(10), the corresponding difference referred to in Article 7(6) of Regulation (EU) No 909/2014 shall be deemed paid.

* Footnote added by ICMA. This would normally be expected to read “lower”, rather than “higher”, to be consistent with market practice. In the case that the price agreed at the time of the trade is *higher* than the price paid for the execution of the buy-in, the corresponding difference is normally paid **by** the receiving party **to** the failing party.

CSDR mandatory buy-ins & SFTs

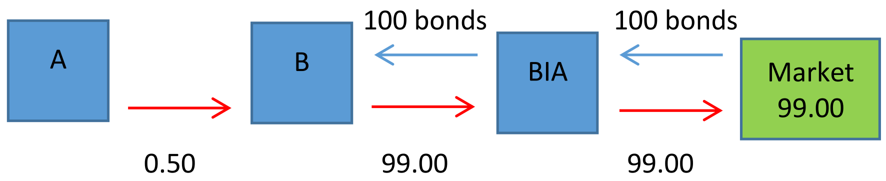
CSDR mandatory buy-in

Original trade



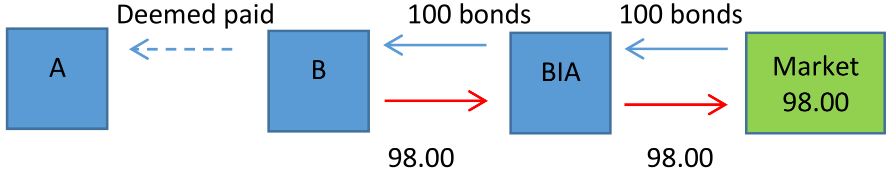
- In other words, the CSDR asymmetry has the potential to change the economics of the original trade

Buy-in at a higher price



	A	B
P&L before buy-in	(0.50)	+0.50
P&L after buy-in	(0.50)	+0.50
P&L impact of buy-in	0	0

Buy-in at a lower price *



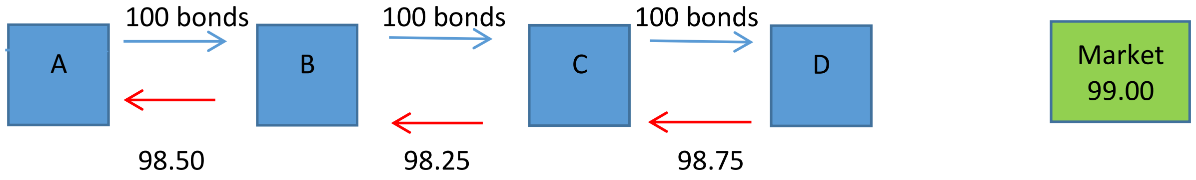
	A	B
P&L before buy-in	+0.50	(0.50)
P&L after buy-in	0	0
P&L impact of buy-in	(0.50)	+0.50

* This is the economic equivalent of the seller of bonds also writing a ‘free’ at-the-money put option which becomes active in the event of a buy-in. The purchaser is effectively long the put.

CSDR mandatory buy-ins & SFTs

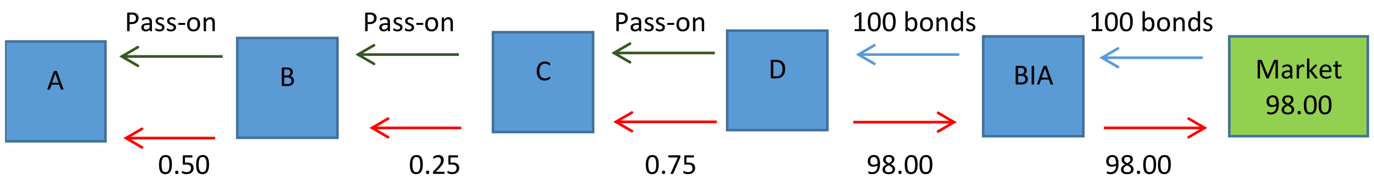
The impact of the CSDR asymmetry on buy-in chains

Original trade



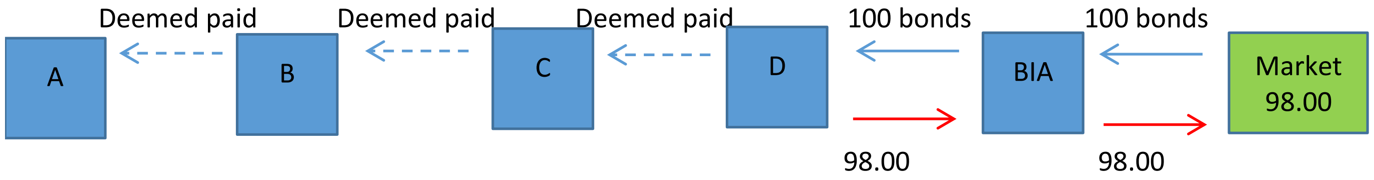
	A	B	C	D
P&L	(0.50)	(0.25)	+0.50	+0.25

Conventional buy-in with 'pass-on'



	A	B	C	D
P&L before buy-in	0	(0.25)	+0.50	(0.25)
P&L after buy-in	0	(0.25)	+0.50	(0.25)
P&L impact of buy-in	0	0	0	0

CSDR buy-in



	A	B	C	D
P&L before buy-in	+0.50	(0.25)	+0.50	(0.75)
P&L after buy-in	0	0	0	0
P&L impact of buy-in	(0.50)	+0.25	(0.50)	+0.75

4. Considerations for in-scope SFTs

CSDR mandatory buy-ins & SFTs

Buy-ins generally do not apply to SFTs because….

- From a market perspective, SFTs are not outright sales or purchases of securities, they are loans or borrows of securities.
- While SFTs may look like two separate transactions (a sale and a purchase), contractually they are single transactions.[1]
- The revenue (or profit and loss) generated from an SFT derives from the repo or lending rate (or fee) applied to the transaction, and not from market moves in the value of the underlying securities.
- Unlike outright cash trades, SFTs are margined. This can be in the form of variation margin, to ensure that the value of the cash loan remains in line with the value of the underlying securities, and also in the form of initial margin, through the application of haircuts.
- It is also important to remember that under the contractual agreements for SFTs (namely GMRAs and GMSLAs in the European context), there are no provisions to buy-in against a failing SFT. This is because in most scenarios it would make no sense to do so.

[1] From a legal perspective a SFT may be contractually structured as a title transfer arrangement, involving an outright sale and repurchase.

CSDR mandatory buy-ins & SFTs

Challenges of applying mandatory buy-ins to SFTs

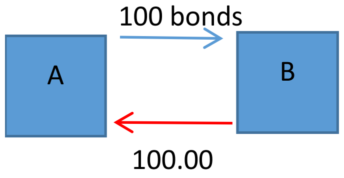
- If you buy-in against the start-leg, does the end-leg remain valid?
- If a buy-in against the start-leg results in cash compensation, what happens to the end leg? Does that remain valid?
- How is the settlement of the buy-in/cash compensation determined? Is this based on the price assigned to the start-leg?
- How do you apply the asymmetry to buy-ins against SFTs?
- How do you account for haircuts in determining the appropriate buy-in/cash compensation differential payment? Does the asymmetry still apply in the case of haircuts?
- What happens to open trades if they reach 30 business days?
- Will CCPs require separate netting pools for in- and out-of-scope SFTs?
- How do you manage the buy-in risk in a matched-book with both in- and out-of-scope SFTs?

CSDR mandatory buy-ins & SFTs

How do you buy-in a start-leg?

Original trade

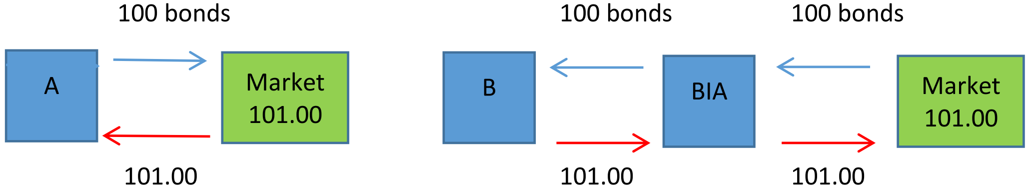
Start-leg

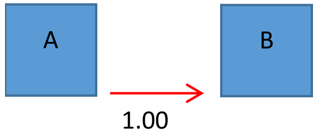


Orignal Transaction					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
SFT SL	+€100mm	-100mm XYZ bonds	SFT SL	-€100mm	+100mm XYZ bonds
SFT EL	-€100.25mm	+100mm XYZ bonds	SFT EL	+€100.25mm	-100mm XYZ bonds
Net	-€0.25mm		Net	+€0.25mm	

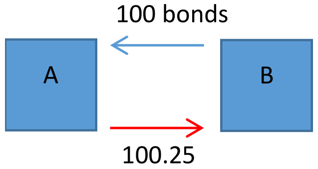
Buy-in against start-leg

Buy-in





End-leg



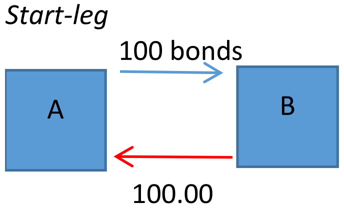
In this scenario the lending counterparty (A), will need to sell bonds in the market, once they are bought-in. A's risks relate to the buy-in premium (i.e. the difference between the buy-in price and prevailing market price).

Post CSDR buy-in					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
Sale	+€101mm	-100mm XYZ bonds	Buy-in	-€101mm	+100mm XYZ bonds
Buy-in differential	-€1mm		Buy-in differential	+€1mm	
SFT EL	-€100.25mm	+100mm XYZ bonds	SFT EL	+€100.25mm	-100mm XYZ bonds
Net	-€0.25mm		Net	+€0.25mm	

CSDR mandatory buy-ins & SFTs

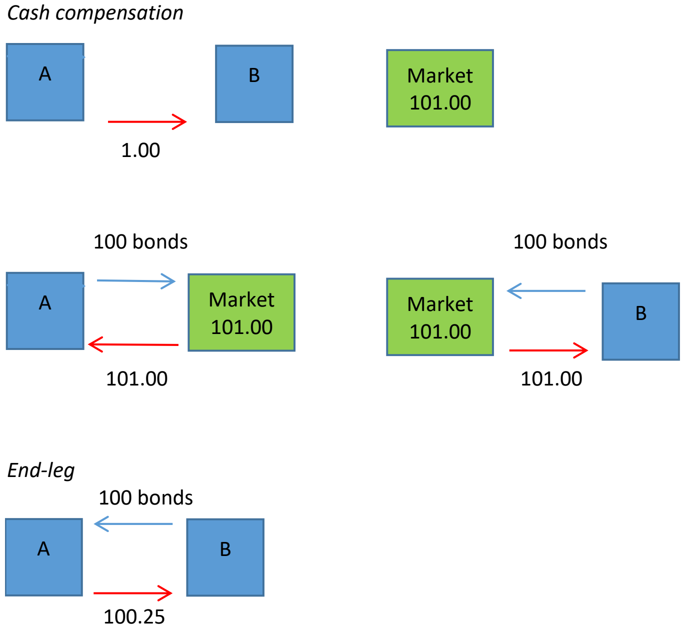
What happens if the start-leg results in cash compensation?

Original trade



Orignal Transaction					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
SFT SL	+€100mm	-100mm XYZ bonds	SFT SL	-€100mm	+100mm XYZ bonds
SFT EL	-€100.25mm	+100mm XYZ bonds	SFT EL	+€100.25mm	-100mm XYZ bonds
Net	-€0.25mm		Net	+€0.25mm	

Cash compensation against start-leg



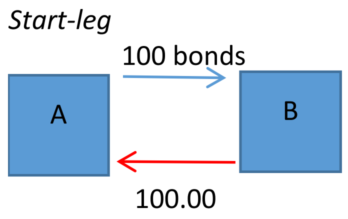
In this scenario there is no delivery/receipt of bonds, so B will be required to purchase bonds in the market, while A will need to sell bonds in the market. This creates market risks for both parties, related to the difference between the cash compensation reference price and their subsequent market transactions.

Post CSDR cash compensation					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
Cash comp differential	-€1mm		Cash comp differential	+€1mm	
Sale	+€101mm	-100mm XYZ bonds	Purchase	-€101mm	+100mm XYZ bonds
SFT EL	-€100.25mm	+100mm XYZ bonds	SFT EL	+€100.25mm	-100mm XYZ bonds
Net	-€0.25mm		Net	+€0.25mm	

CSDR mandatory buy-ins & SFTs

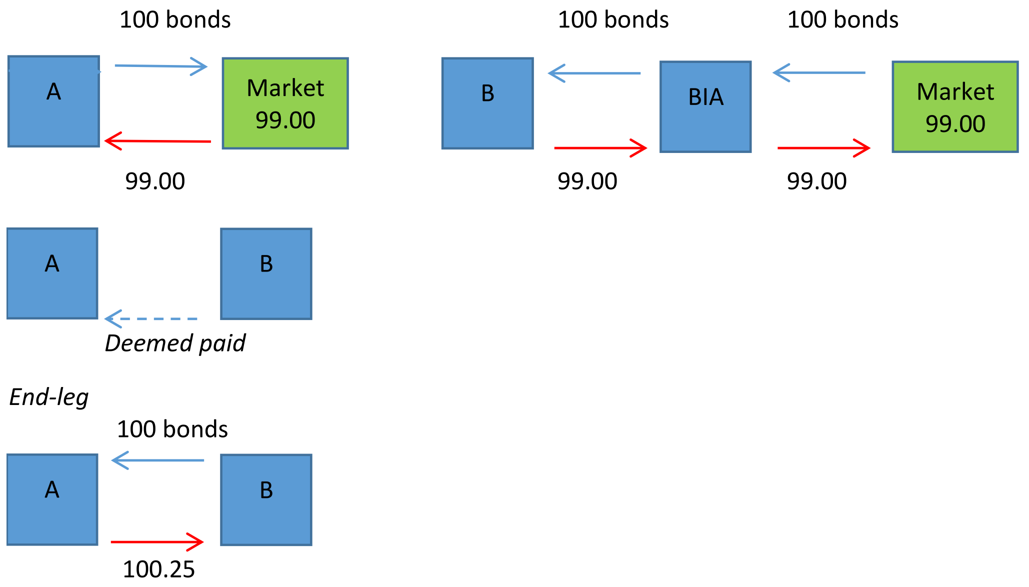
Applying the CSDR asymmetry to SFTs

Original trade



Orignal Transaction					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
SFT SL	+€100mm	-100mm XYZ bonds	SFT SL	-€100mm	+100mm XYZ bonds
SFT EL	-€100.25mm	+100mm XYZ bonds	SFT EL	+€100.25mm	-100mm XYZ bonds
Net	-€0.25mm		Net	+€0.25mm	

Buy-in against start-leg



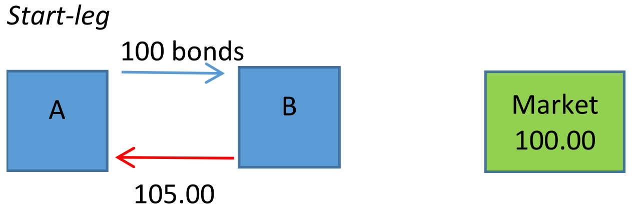
As with outright cash trades, the asymmetry of the CSDR buy-in process creates additional downside market risks for the delivering SFT counterparty (and the opportunity for windfall profits for the receiving counterparty).

Post CSDR buy-in					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
Sale	+€99mm	-100mm XYZ bonds	Buy-in	-€99mm	+100mm XYZ bonds
Buy-in differential	Deemed paid		Buy-in differential	Deemed paid	
SFT EL	-€100.25mm	+100mm XYZ bonds	SFT EL	+€100.25mm	-100mm XYZ bonds
Net	-€1.25mm		Net	+€1.25mm	

CSDR mandatory buy-ins & SFTs

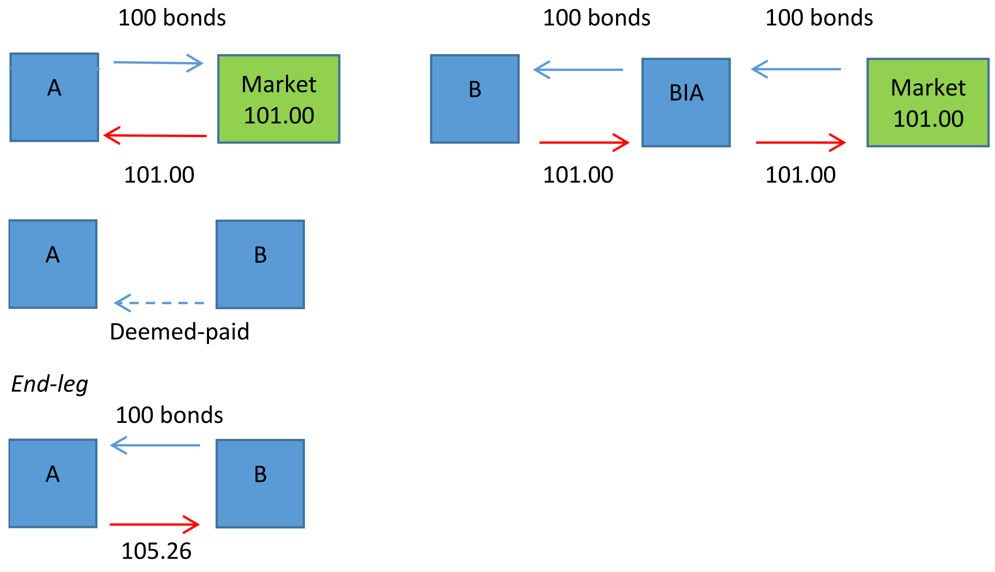
CSDR mandatory buy-ins with haircuts

Original trade



Orignal Transaction					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
SFT SL	+€105mm	-100mm XYZ bonds	SFT SL	-€105mm	+100mm XYZ bonds
SFT EL	-€105.26mm	+100mm XYZ bonds	SFT EL	+€105.26mm	-100mm XYZ bonds
Net	-€0.26mm		Net	+€0.26mm	

Buy-in against start-leg



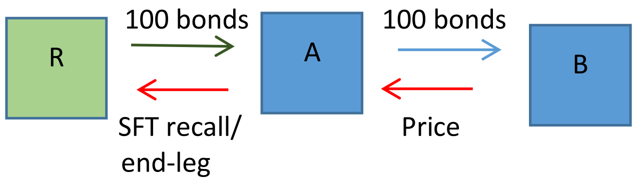
Applying the CSDR buy-in process as written, without adjusting for haircuts, could result in significantly unusual economic outcomes. Again, this caused by the asymmetry.

Post CSDR buy-in with haircut					
A	*Cash*	*Securities*	**B**	*Cash*	*Securities*
Sale	+€101mm	-100mm XYZ bonds	Buy-in	-€101mm	+100mm XYZ bonds
Buy-in differential	Deemed paid		Buy-in differential	Deemed paid	
SFT EL	-€105.26mm	+100mm XYZ bonds	SFT EL	+€105.26mm	-100mm XYZ bonds
Net	-€4.26mm		Net	+€4.26mm	

5. Considerations for out-of-scope SFTs

CSDR mandatory buy-ins & SFTs

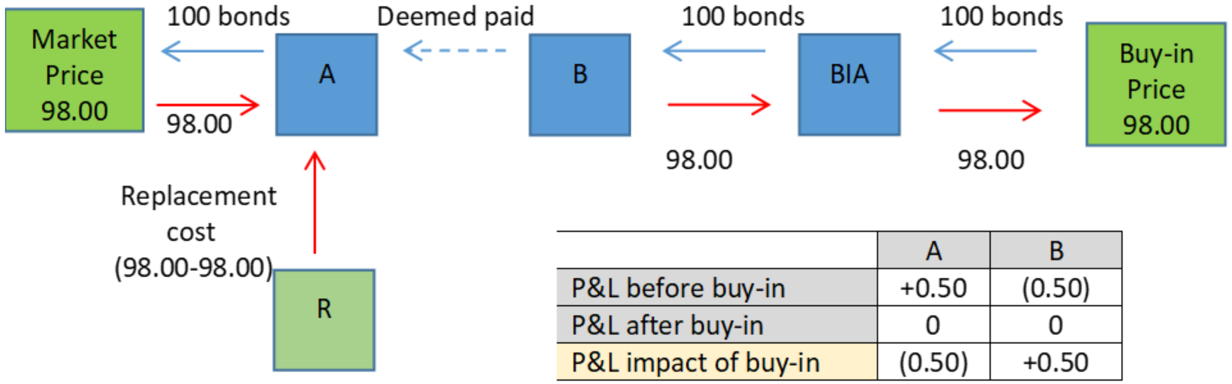
The link between SFTs and cash trades: the impact of the asymmetry on failing end-legs



As discussed previously, while it is not possible to 'pass-on' a cash market buy-in under a GMRA/GMSLA, it may be possible to pass-on any buy-in costs through the mini close-out mechanism, since it could be argued that the buy-in cost is effectively the cost of replacing the securities.

Under CSDR, the risks of buy-ins increase, thus the ability to pass-on buy-in costs through a mini close-out will be tested more frequently. Also, even if it is possible to pass-on regular buy-in costs through the mini close-out mechanism, it will not be possible to pass-on any costs resulting from the CSDR asymmetry.

So, lenders of securities will face much higher risks and potential losses in the event of failing SFTs.



	A	B
P&L before buy-in	+0.50	(0.50)
P&L after buy-in	0	0
P&L impact of buy-in	(0.50)	+0.50

6. ICMA Impact study

CSDR mandatory buy-ins & SFTs

ICMA International Capital Market Association

ICMA Bond Market Impact Study (2019)

- **Follows up on ICMA's 2015 Bond Market Impact Study**

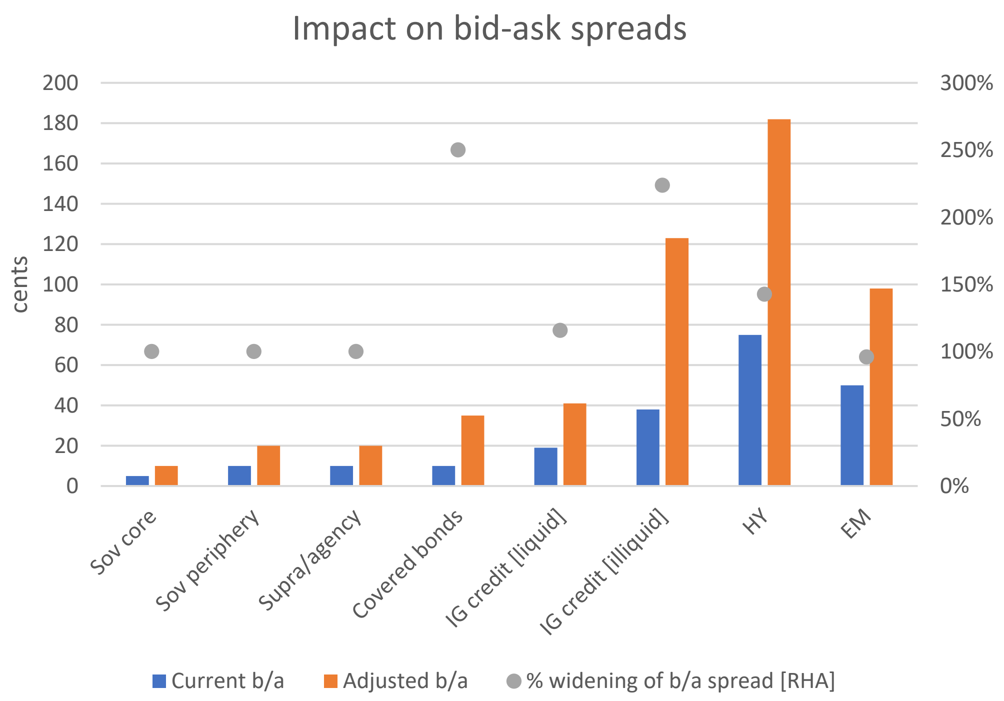
- **Study sets out to answer five questions with respect to the CSDR mandatory buy-in regime:**
  - (i) What is the general preparedness of firms both from an operational and trading strategy perspective?
  - (ii) How will sell-sides adjust their pricing and liquidity provision across a range of bond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

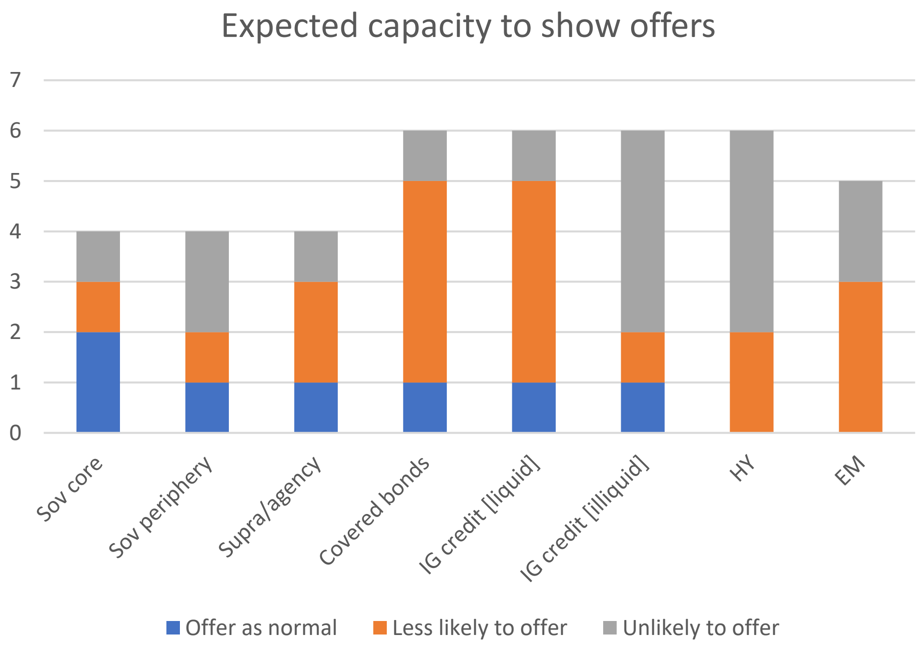
- **Methodology**
  - Survey based with three survey templates: sell-side, buy-side, repo and securities lending desks
  - 44 responses, representing buy-side firms (16), sell-side firms (16), and repo and securities lending desks (12).

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

CSDR mandatory buy-ins & SFTs

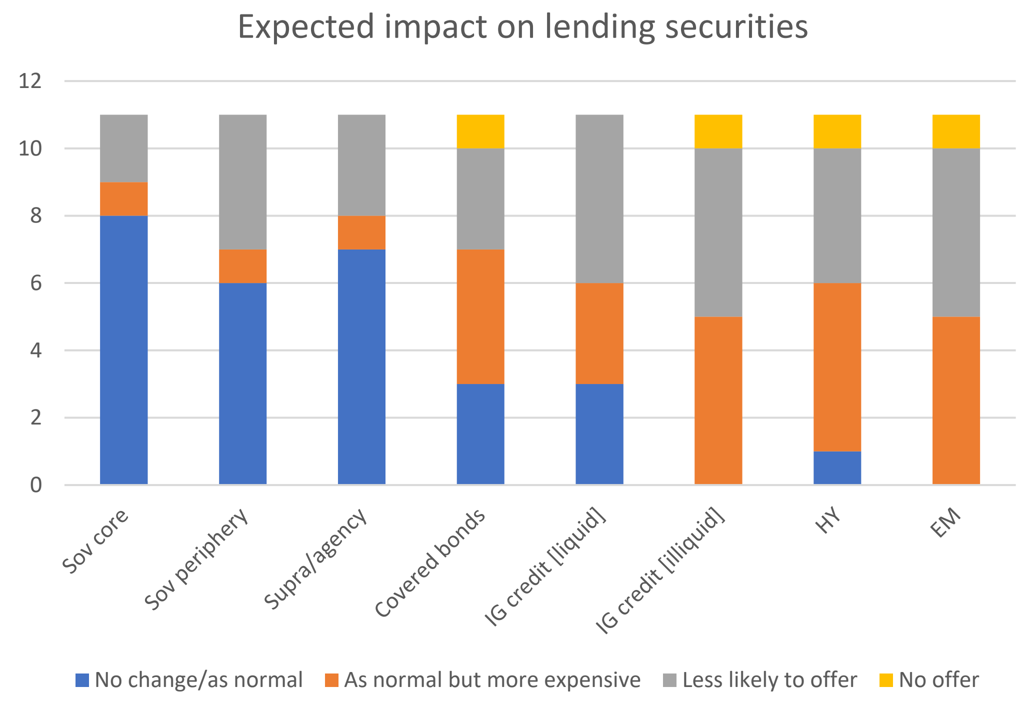
Sell-side pricing and liquidity (bonds)

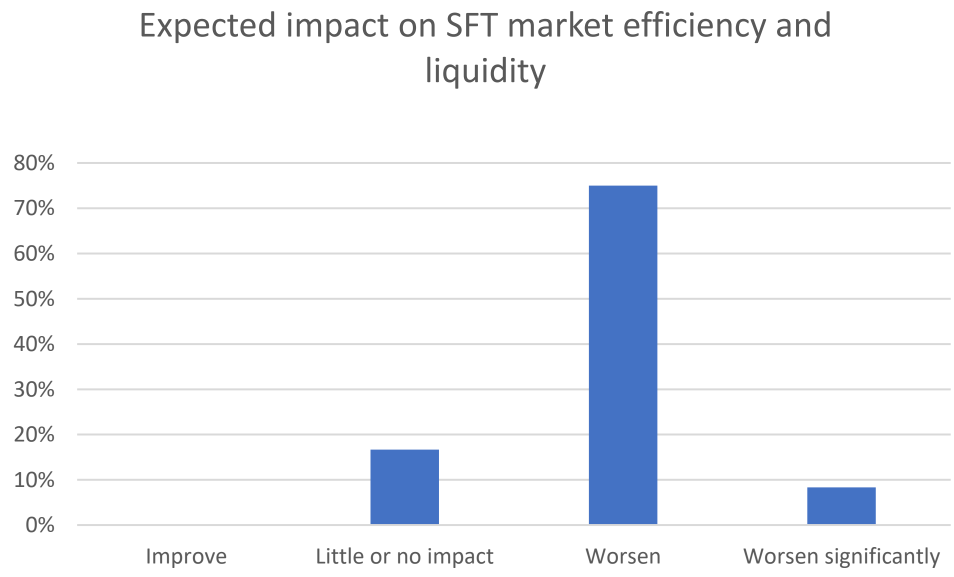




CSDR mandatory buy-ins & SFTs

Repo and securities lending





7. Current state of play

CSDR mandatory buy-ins & SFTs

CSDR Mandatory Buy-Ins

Q1 2021
European Commission Targeted Review

Q3 2021
European Commission Report (on consultation) and Recommendations

Q4 2021
Likely legislative proposal (concrete amendments and impact assessment)

February 1, 2022
CSDR-SD 'go live'

Recent developments

- **February 2021:** ICMA submitted response to CSDR Targeted Review
- **March 2021:** ICMA held pen on cross-industry letter (15 TAs) to the McGuiness cabinet highlighting concerns around implementation and the review process timelines
- **May 2021:** Commission responds to say that they are aware of the issue and are conducting a market impact assessment, based on which they will determine the concrete amendment proposals to CSDR (to be further modified by the Parliament and the Council over the following 15-18 months minimum)
- **May 2021:** ISLA, ICMA, AFME, AGC share with DG FISMA an indication of the scale of the contractual work required to comply with MBIs.
- **July 2021:** European Commission publishes report of Targeted Review. Confirms no decision on MBIs which will be subject to an impact assessment in H2 2021. Any legislative proposals likely toward the end of 2021.

CSDR mandatory buy-ins & SFTs

ICMA
International Capital Market Association

CSDR Mandatory Buy-Ins

Q1 2021
European Commission Targeted Review

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European Commission Report (on consultation) and Recommendations

Q4 2021
Likely legislative proposals (concrete amendments and impact assessment)

February 1, 2022
CSDR-SD 'go live'

Implementation

- Work on **contractual implementation** (required under Article 25) had been put on hold pending the CSDR Review. Original intention was to create market specific solutions (e.g. updating the ICMA Buy-in Rules, producing a GMRA Annex for repos)
- Given lack of clarification on the necessary revisions needed to the regulation, and no indication of a change in go-live date, the industry is moving toward a **two-phase implementation approach**, starting with ‘bare bones’, product agnostic legal wording that can be used by market participants. A second stage of more bespoke contractual frameworks, with required commercial enhancements, will follow clearer guidance or regulatory amendments.
- **August 2021**: It is understood that the Commission and Member States agreed to delay implementation of MBIs. Commission and ESMA Legal Services instructed to find appropriate statutory instrument to decouple MBIs from the Settlement Discipline regime.

CSDR mandatory buy-ins & SFTs

Conclusion

- CSDR Settlement Discipline (due to come into force in February 2022) creates a regulatory obligation for trading parties to buy-in failing (selling) counterparties.
- The regulatory obligation to buy-in is based on the jurisdiction of the (I)CSD and the nature of the underlying security – regardless of the domicile or jurisdictions of the trading parties.
- The regulation sets out very precise guidelines for the buy-in process, including timings.
- The buy-in mechanism has an asymmetry in how the buy-in cash flows are settled. In many cases this will create windfall profits for the failed-to party and additional market risks and losses for the failing party. This is broadly understood to be the unintended consequence a drafting error in the Level 1 text that cannot be changed.
- Mandatory buy-ins will apply to SFTs (≥ 30 business days' term). However, there are a number of complications and ambiguities as to how buy-ins can be applied, which will need to be addressed.
- Due to the inherent relationship between cash and SFT markets, the regulation will also have a significant indirect impact on repo and securities lending, not least as a result of the asymmetry.
- The CSDR mandatory buy-in regime is widely expected to have disproportionate negative impacts with respect to European capital market efficiency, liquidity, and stability.
- As of Q3 2021, it is understood that following agreement from the EU Member States that MBIs should be delayed, pending the outcome of the impact assessment, the European Commission and ESMA Legal Services are exploring ways to decouple MBIs from the SD regime.

CSDR mandatory buy-ins & SFTs

Related ICMA Papers:

ICMA Briefing note outlining the need to postpone mandatory buy-ins
July 2021

ICMA response to the European Commission Targeted consultation on the review of CSDR
February 2021

ICMA Briefing note on CSDR MBIs and the requirement to appoint a buy-in agent
September 2020

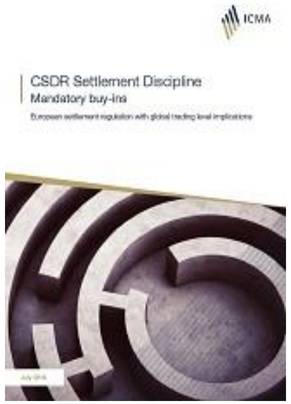
ICMA Briefing note outlining identified deficiencies in the CSDR provisions for cash compensation
May 2020

FAQs on CSDR mandatory buy-ins and Securities Financing Transactions
March 2020

Mandatory buy-ins under CSDR and the European bond markets: Impact Study
November 2019

CSDR Settlement Discipline: mandatory buy-ins
August 2019 (Information Brochure)

CSDR mandatory buy-ins and securities financing transactions
October 2018 (Discussion Paper)



CSDR mandatory buy-ins & SFTs

Regulatory texts:

CSD- Regulation (EU) No 909/2014 [“Level 1”]

Delegated Regulation (“Level 2”) 25.5.2018 [RTS for Settlement Discipline]

Delegated Regulation (modified) 27.1.2021 [amending implementation date to 1 Feb 2022]

CSDR Frequently Asked Questions (September 2014)

More information and resources can be found on the dedicated CSDR-SD page on the ICMA website:
https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-markets-regulation/csdr-settlement-discipline/

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