To:

Valdis Dombrovskis
Executive Vice-President for An Economy that Works for People
European Commission
1049 Bruxelles

30 January 2020

Dear Executive Vice-President Dombrovskis,

Request regarding the CSD Regulation provisions for mandatory buy-ins

On behalf of our member firms, comprising European and global asset managers and investment firms, the Investment Association (IA)[i] and the International Capital Market Association's (ICMA's) Asset Management and Investors Council (AMIC)[ii] are sending this letter to express concerns about the potential bond market impacts of the mandatory buy-in provisions in the EU's CSD Regulation, which are expected to come into force in early 2021.

Our respective members wish to make clear that they are fully supportive of all constructive efforts, whether private or public, to improve settlement efficiency in the European Union. This includes the use of buy-in and sell-out provisions, which are an important contractual remedy for settlement fails and a useful tool for managing settlement risk.[iii] Nevertheless, our members are concerned that the buy-in provisions specified in the CSDR, while well-intentioned, will prove to be unduly harmful to the functioning, liquidity, and stability of the EU's bond markets.

The CSDR buy-in provisions differ legally, structurally, and economically from existing contractual buy-in remedies used in the non-cleared bond markets. These significant differences undermine the effectiveness of EU CSDR mandatory buy-ins as a bond market settlement risk mitigant. In stark contrast, these provisions are specified in such a manner that they are widely expected to serve to increase market risks markedly, both for liquidity providers and investors. In turn, this could have unintentional detrimental consequences for issuers raising capital in the EU's bond markets.

Buy-ins, as used in the non-cleared bond markets, are usually a contractual right, rather than a legal obligation. This allows buyers discretion as to when they judge to be the opportune time to issue a buy-in in the event of a settlement fail. This allows the buyer to select the timing and market conditions for when a buy-in can be best executed, as well as affording their counterparty the appropriate time to deliver securities, based on the relative liquidity or scarcity of the underlying securities, and also allowing for market conditions. This discretion provides a degree of comfort to market-makers and other liquidity providers who in most cases are unlikely to hold the securities they are requested to offer to investors, who may be unable immediately to cover their sale, and are reliant on repo market liquidity.

As well as having discretion as to when best to initiate a buy-in, buyers generally have autonomy as to the timeframe in which to execute the buy-in, as well as the option to terminate and re-commence the buy-in. Again, this flexibility helps investment firms to manage the best execution parameters of a buy-in, as well as balancing the trade-off between enforcing timely delivery of their securities and the ability to source liquidity. Furthermore, while conventional buy-ins do not preclude the ability for parties to negotiate cash settlement in the event of a prolonged settlement fail, they do not enforce it. Enforced cash settlement (as with the cash compensation provisions in CSDR) creates direct risks for buyers of securities (investors) who, without any control, are forced out of a position or holding, based on a reference price over which they, again, have no determination. In this instance, investors may struggle to replace the exposure they originally intended to enter into and may also be forced to unwind contingent exposures (such as cash or derivative hedges or FX exposures), exposing the underlying investor to unintended economic risks and potentially significant market losses. This could, in turn, lead to breaches in investment mandates. This issue alone represents an extremely significant risk of the mandatory buy-in provisions.

Finally, conventional discretionary buy-ins are not intended to change the economics of the original transaction and certainly not to generate random 'winners' and 'losers'. Seemingly as a result of what appears to be an error in the Level 1 text relating to the payment of the buy-in differential amount,[iv] the regulatory technical standards apply an asymmetric treatment regarding how the CSDR buy-in or cash compensation are settled, potentially to the detriment of the seller. Under certain circumstances, this will generate (unlimited) market gains for the buyer and (unlimited) market losses for the seller, over and above any usual costs associated with a buy-in. This is the economic equivalent of any seller of securities being short an at-the-money put option in the event of a buy-in. This is an additional, and largely unquantifiable, risk which will be borne by market-makers and liquidity providers, beyond those already resulting from the mandatory obligation and inflexible nature of the CSDR buy-in provisions.

It soon becomes clear that the CSDR mandatory buy-in provisions provide a significant deterrent to the appropriate short-selling of securities as a necessary part of market-making or liquidity provision services.[v] Furthermore, the increased risks created by the CSDR provisions also apply to intermediaries (who may have matched purchases and sales) as well as lenders of securities (who risk being bought-in, often with little recourse, if their securities are not returned on time).

These risks are likely to result in increased costs and liquidity risks for investors, as market-makers and other liquidity providers adjust their pricing to reflect the increased risks which they will face when selling securities, or in many cases to simply retract from showing offers in securities that they do not already hold in inventory. Similarly, investors will be forced to reflect the increased risks associated with securities lending, either in their pricing or by lowering their propensity to lend certain securities or asset classes.

These impacts on liquidity and pricing are highlighted in ICMA's *Impact Study of CSDR Mandatory Buy-ins on the EU Bond Markets.*[vi] This study clearly illustrates that the effects of increased costs and reduced liquidity will be felt most severely in less liquid sub-classes of bonds, in particular corporate, high yield, and emerging market bonds. The findings suggest that not only will bid-offer spreads widen meaningfully across all affected asset classes, but in the case of less liquid markets, market makers will withdraw from providing liquidity altogether. Furthermore, these effects are likely to be compounded by a similar, indirect impact on liquidity in the repo and securities lending markets. This comes at a time when there are already widespread concerns around declining liquidity in certain segments of the European secondary bond markets (including corporate bonds), and with much attention on fixed income fund liquidity.

While these increased risks and costs will directly impact end investors, they are also likely to have unintended detrimental impacts for issuers raising capital in the EU's bond markets. As secondary market liquidity becomes impaired, it must be anticipated that there will be a consequent increase in borrowing costs for new issuers, and for some it may even restrict market access. Again, this will be most severely felt by smaller, less frequent or potentially new corporate or sovereign issuers. This would seem to conflict directly with the goals of capital markets union, which look to foster deep and efficient bond markets, not to constrain them.

In light of the significant potential for undesirable consequences to European bond market functioning, liquidity, and stability, our members request that the European Commission and co-legislators carefully reconsider the scope of application of the CSDR mandatory buy-in requirements. In particular, our members ask that while other CSDR settlement discipline provisions, including the cash penalty requirements, are implemented as early as practicable, the application of the mandatory buy-in provisions be delayed pending a detailed market impact analysis of the potential effects across all asset classes, especially the least liquid segments of the European capital markets. Given the potential consequences of the buy-in regime, a robust market impact assessment is viewed as a critical consideration in informing the design and calibration of any buy-in framework, if it is to be effective.

In case of proceeding in the absence of such an impact analysis, our members request that upon its initial introduction, cash bond markets are excluded from the CSDR mandatory buy-in provisions. Following a suitable period to monitor and evaluate the impact of the provisions on equity market pricing, liquidity, and stability, it should be possible to assess whether, or not, it is appropriate to extend the provisions to bond markets, or certain more liquid sub-classes of bonds. It is noted that ESMA took an appropriately cautious approach in designing and implementing the transparency regime for bonds under MiFID II/R, attempting to establish a balance of achieving the objectives of the regulation without unduly harming market liquidity and efficiency. This has entailed starting from a relatively conservative application of the measures, with a phased-in approach based on an ongoing assessment of market impacts.

Given that the risks for bond market liquidity, efficiency, and stability seem to be equally meaningful with respect to the implementation of the CSDR buy-in framework, it appears justifiable to argue that a modification to the RTS to allow for a more market-sensitive and phased application of the requirements, based on a thorough evaluation of market impacts, would be expedient.

Our members feel that such a cautious approach to phasing-in the mandatory buy-in requirements, based on the careful assessment of market impacts, will ultimately be in the best interests of investor protection, market stability, and the goals of the capital markets union.

Yours sincerely,

Galina Dimitrova
Director, IA
Investment & Capital Markets

David Hiscock
Managing Director, ICMA
Secretary to the AMIC

Copy:

Steven Maijoor
Chair of the European Securities and Markets Authority

John Berrigan
Acting Director-General, DG FISMA

Patrick Pearson
Head of Financial Markets Infrastructure, DG FISMA

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[i] The IA's members range from small, independent UK investment firms to Europe-wide and global asset managers, collectively managing over £7.7 trillion assets on behalf of their clients in the UK and around the world.

[ii] ICMA's AMIC represents ICMA's buy-side membership and is a fully structured council, encompassing over 230 contacts across a broad range of European and global asset managers and investment firms.

[iii] Buy-ins, and their mirror mechanism, sell-outs, are used in the non-cleared bond markets as a contractual means to force delivery of securities or cash in the case of a settlement fail. The purpose is to restore the parties to the failing transaction to the economic position they would have been in had the original trade settled.

[iv] Article 7(6) appears to have the direction of the payment between the parties going in the wrong direction. This is partly corrected in the Level 2 RTS, but only in the case that the buy-in or cash compensation reference price is higher than the original trade price.

[v] This is a particularly significant issue in the corporate bond market. Market-making is a far more integral aspect of the corporate bond market than in equity trading, and it is common for corporate bond market-makers to short-sell bonds to facilitate the mismatch in timing between the appearance of buyers and sellers. This consideration is even more intrinsic to market structure due to the significantly larger number of corporate bonds in circulation than equities.

[vi] See: 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