ICMA

International Capital Market Association

Response to the Call for Evidence: EU regulatory framework for financial services

January 20th 2016

Executive Summary

Introduction

ICMA, on behalf of its members, welcomes the opportunity to respond to the European Commission's 'call for evidence' and is pleased that such an important initiative has been included as part of the Capital Markets Union (CMU) project.

The International Capital Market Association represents some 500 members across more than 60 countries, including issuers, primary and secondary market intermediaries, asset managers, investors, and capital market infrastructure providers. The mission of ICMA is to promote resilient and well-functioning international debt capital markets, which it views as necessary for economic growth, and which benefit market participants and their clients alike. ICMA and its members therefore applaud and fully support the objectives of CMU, which recognizes the need for stronger capital markets to strengthen long term investment and to bolster the link between savings and growth within the European Union; a goal that has been at the heart of ICMA's work for almost 50 years.

ICMA further recognizes that underpinning strong and functioning capital markets has been the need to restore financial stability and public confidence in the financial system following the crisis of 2007-08. Accordingly, the development of the new regulatory framework, including many of the global, European, and national initiatives has been necessary and welcomed, and ICMA will continue to support the development and the successful and effective application of constructive financial regulation.

However, as the Commission has recognized, the sheer volume and detail of regulation has made predicting the effectiveness of individual rules and provisions difficult, while identifying cumulative impacts, particularly the potential for adverse unintended or counterproductive outcomes, is extremely challenging. Furthermore, as the Commission notes, many rules have not yet been fully implemented, and much of the detail remains to be finalized. Accordingly, the request for data and empirical evidence at this stage in the implementation process may not highlight sufficiently the extent of the risks to financial market efficiency and stability that some of the regulation, whether in isolation or in accumulation, is creating. Therefore, ICMA and its members hope that this "call for evidence" is the first step in a continual process of consultation with market stakeholders, in particular capital raisers and investors, to help refine and improve the regulatory process, and to ensure the successful attainment of intended outcomes. However, ICMA believes that such a call for evidence at this time is still highly relevant, and provides a valuable and timely opportunity to promote dialogue around potential weaknesses in the regulatory framework, as well as to highlight potential risks to the objectives of both financial regulation and CMU.

ICMA's approach to the response

Given the relatively short timeframe of the consultation for providing evidence and concrete feedback across a broad range of thematic areas and issues, ICMA has chosen to focus primarily on the issue of **market liquidity** within the context of **rules affecting the ability of the economy to finance itself and grow** ('A2' in the response template). This has been a high priority for ICMA for a number of years, and so the response draws on much of the work and research it has undertaken previously related to both European corporate bond secondary market liquidity and collateral and repo market liquidity. ICMA believes that efficient and stable capital markets require a healthy degree of liquidity[1], which is essentially the ability for investors and capital raisers to meet, and a key component in strengthening the link between savers and economic growth. As ICMA has maintained in its recent work on the evolution of the corporate bond and collateral markets, market liquidity should be viewed as a "public good" and the collective responsibility of those who provide, use, and oversee capital markets.

While drawing on a number of relevant studies and papers, published by ICMA and others, the four key studies referenced in this response are:

- *(i)* *Perspectives from the eye of the storm: the current state and future evolution of the European repo market* (ICMA, 2015);
- *(ii)* *Impact study for CSDR mandatory buy-ins* (ICMA, 2015);
- *(iii)* *The current state and future evolution of the European investment grade corporate bond secondary market: perspectives from the market* (ICMA, 2014);
- *(iv)* *Collateral is the new cash: the systemic risks of inhibiting collateral fluidity* (ICMA, 2014).

These papers as based on extensive consultation with, and input from, ICMA's broad and diverse membership, including sell-side and buy-side firms, as well as issuers and other market stakeholders. The studies highlight potential risks to the efficient functioning of both the corporate bond and repo (or collateral) markets, primarily as the result of cumulative regulatory initiatives. While the key points are presented in this response, ICMA would respectfully request that the Commission refer to these studies and their findings and treat them as an integral part of the ICMA response.

This ICMA response has been prepared in close consultation with its members, in particular the below constituent committees and forums which represent a broad spectrum of European capital market stakeholders, including issuers, investors, and intermediaries:

Corporate Issuer Forum
Asset Management and Investors Council
Secondary Market Practices Committee
European Repo and Collateral Committee
Regulatory Policy Committee

[1] ICMA defines a liquid market as one in which prices are continuously available, in reasonable size, and in which multiple participants can transact in their desired size over acceptably short timeframes without material adverse price impact.

Summary of recommendations

Example 1	**European corporate bond secondary market liquidity**
Directive(s) and/or Regulation(s)	CRD IV [Directive 2013/36/EU] /CRR [Regulation (EU) No 575/2013]; EMIR [Regulation 848/2012]; MiFID II [Directive 2014/65/EU] / MiFIR [Regulation (EU) No 600/2014]**;** CSDR [Regulation 909/2014]
Summary of example	Fixed income markets, in particular corporate bond markets, require market-maker intermediation to provide secondary market liquidity. A number of different regulatory initiatives threaten to undermine the ability of the market-making model to function effectively and efficiently. This poses serious risks to both investors and corporate issuers, and hence the real economy.
Suggestions	❖ Careful review and analysis of the potential implications and impacts of Basel measures as implemented under CRD IV/R, not least the calibrations of the Net Stable Funding Ratio and the Fundamental Review of the Trading Book, both of which threaten to raise the cost of capital for market-making activity even further. ❖ Further review of the pre- and post-trade transparency calibrations of MiFID II/R, including exemption and deferral waivers, to reflect more accurately the typical lack of underlying bond market liquidity, particularly during the post-issuance stage. ❖ Extended deferral of the implementation of mandatory buy-ins under CSDR, or at least until an extensive and transparent market impact assessment has been conducted (see Example 3). ❖ Measures to improve the liquidity and resilience of the repo market (see Example 2). ❖ A modification to EMIR to allow for uncovered position of CDS, to help re-liquefy this important hedging market.

Example 2	**Repo market liquidity and collateral fluidity**
Directive(s) and/or Regulation(s)	CRD IV [Directive 2013/36/EU] /CRR [Regulation (EU) No 575/2013]; CSDR [Regulation 909/2014]; MiFID II [Directive 2014/65/EU] / MiFIR [Regulation (EU) No 600/2014]**;** SFTR [COM/2014/040]; BRRD [Directive 2014/59/EU]
Summary of example	The repo market provides a number of critical functions for the smooth and efficient operation of capital markets, including secured funding, financing and pricing bond and derivatives markets, mobilizing collateral, and transmitting monetary policy. The confluence of a broad suite of regulatory initiatives threatens the stability and liquidity of the European repo market, both directly and indirectly, which in turn has potentially negative implications for the real economy.
Suggestions	❖ Increased scope under NSFR to allow for the application of

	netting, or off-setting, of interdependent assets and liabilities, in particular in the context of intermediated 'matched' repo and securities lending transactions and inventory financing. ❖ More focused and less onerous reporting requirements under SFTR, that are also broadly consistent with other SFT reporting initiatives, would not only minimize costs and disincentives for repo market liquidity providers and consumers, but would also provide scalability and efficiency for the authorities who are expected to compile, process, and interpret the data. ❖ Repo and other securities financing transactions should be removed from pre- and post-trade transparency requirements under MiFID II/R, as well as transaction reporting and best execution obligations, on the grounds that this provides no useful purpose. ❖ Resolution stays should be subject to the maintenance of payments (as in fact stated in BRRD Article 71) and it should not be possible to override this using powers to invoke payment suspensions (under BRRD Article 69). Furthermore, there should be symmetry of treatment for cleared and non-cleared transactions. ❖ Extended deferral of the implementation of mandatory buy-ins under CSDR , or at the very least maximizing the term of SFTs for which the near-leg of SFTs are exempted under the regulation, so as to avoid dis-incentivizing longer-term financing transactions (see Example 3).

Example 3	**CSDR mandatory buy-ins and fixed income liquidity**
Directive(s) and/or Regulation(s)	CSDR [Regulation 909/2014] Article 7
Summary of example	Not only does the introduction of a mandatory buy-in regime have negative implications for bond and financing market pricing and liquidity, which will increase costs and risks to both investors and bond issuers, but the regulation is also flawed and unfit for purpose.
Suggestions	❖ The implementaion of CSDR mandatory buy-ins should be further deferred, at least until an extensive and transparent market impact assessment has been conducted, involving a broad range of market participants and stakeholders. ❖ If mandatory buy-ins are to be implemented, at the very least the asymmetry for payments in the regulation (Articles 7(6) and &(7)) should be addressed to allow for payments to flow in both directions, depending on the original transaction price and the subsequent buy-in or cash compensation reference price. Without doing so, this element of the regulation is not fit for purpose.

The response

A. Rules affecting the ability of the economy to finance itself and grow
Issue 2 - Market liquidity

Please specify whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity. Please elaborate on the relative significance of such impact in comparison with the impact caused by macroeconomic or other underlying factors.

Example 1 for Issue 2

European corporate bond secondary market liquidity

To which Directive(s) and/or Regulation(s) do you refer in your example? (If applicable, mention also the articles referred to in your example.)

CRD IV [Directive 2013/36/EU] /CRR [Regulation (EU) No 575/2013]; EMIR [Regulation 848/2012]; MiFID II [Directive 2014/65/EU] / MiFIR [Regulation (EU) No 600/2014]; CSDR [Regulation 909/2014]

Please provide us with an executive/succinct summary of your example:

ICMA wishes to highlight that it is important for policy makers and regulators to acknowledge that fixed income markets are very different structurally to equity markets. Not only are the securities themselves very different, but the ways in which they are transacted and the underlying sources of secondary market liquidity are also fundamentally distinctive. While there are approximately 6,000 shares traded on regulated markets in Europe, there are more than 150,000 different debt securities. Also, while a firm's equity structure is generally limited to one or two classes of shares, a firm's debt structure usually consists of multiple (in some cases, even several hundreds of) different tradable lines. Furthermore, these bonds, even when from the same issuer, will have different maturities, coupons, issue sizes, covenants, and characteristics related to the seniority and security of the debt, as well as different ratings.

While most shares will trade several times, if not multiple times, per day, the vast majority of bonds will not trade on a daily basis, and may not trade for weeks or even months. Essentially, unlike equities, bonds, as a distinct asset class, can and should be considered to be mostly illiquid. Thus the traditional model for trading bonds is very different to that of equities. While most equities trade actively and visibly, on exchanges, bonds have tended to trade off-exchange, in the over-the-counter market, with liquidity being provided by intermediary market-makers (usually banks or broker-dealers). These market-makers for specific debt securities (usually the same financial institutions that were part of the syndicate for the security's primary issuance) service investors with bids, where they will take the bonds onto their own trading books, or offers, where they will sell the bonds via a short-sale with a view to covering the position with a subsequent market purchase or via the repo market, regardless of whether

or not they have a matched interest in the bond (in most instances they will not). The market-maker will then hedge and fund this position until she is able to trade out of it.

Given the inherent illiquidity and trading infrequency of corporate bonds, and the low probability of matching investor interests, the market-making model provides ready liquidity in the absence of the 'coincidence of want' between matching buyers and sellers of any particular bond at any given time. This source of bond market liquidity is vital for investors who otherwise might struggle to trade in and out of positions in a timely and efficient manner. Any impairment to this secondary market liquidity creates additional risks and costs for investors. Similarly, secondary market liquidity is of vital importance to issuers as it assists in the price discovery process for new issuance. A less liquid secondary market therefore potentially widens the market spread for new issues, creating additional borrowing costs for issuers and so a cost to the real economy.

Buy-side firms obtain quotes from market-makers by contacting them directly, usually via a sales contact, either over the phone or using electronic messaging. Alternatively, some market-makers provide 'single-dealer' electronic trading platforms which their clients can access to request quotes or to transact on firm (executable) prices.

The market-making model is dependent on a number of elements available to the market-making firm: (i) sufficient balance sheet to warehouse long and short positions; (ii) an efficient and liquid hedging market; (iii) an efficient and liquid repo market; (iv) the requisite trading and risk-management skills.

Research by ICMA and others confirm that all of these elements are being seriously compromised by regulation. CRD IV/R provisions have made balance sheet for banks and broker-dealers far more expensive, and the provisions under the Fundamental Review of the Trading Book (FRTB) are expected to increase significantly further the capital charges associated with fixed income market-making. Meanwhile, EMIR has raised the cost of, and restricted the access to, the Credit Default Swap (CDS) market, which facilitates hedging for corporate credit risk; repo market liquidity is becoming ever more precarious (see Example 2); and trading and sales desks are experiencing an ongoing process of 'juniorization' and an attrition of experienced talent.

Further regulatory initiatives, such as CSDR mandatory buy-ins (see Example 3) and MiFID II/R pre- and post-trade transparency requirements, may only serve further to render the market-making model economically unviable and obsolete.

Please provide us with supporting relevant and verifiable empirical evidence for your example: (please give references to concrete examples, reports, literature references, data, etc.)

The ICMA report, *'The current state and future evolution of the European investment grade corporate bond secondary market: perspectives from the market'*, published in November 2014[2], highlights the broad market perception that liquidity in the European corporate bond secondary markets is diminishing, and growing concern that the market may no longer be able to function effectively or efficiently. While largely qualitative, and based on interviews with a range of stakeholders (including institutional investors and asset managers, bank broker-dealers, intermediaries, and corporate issuers), it illustrates the growing challenge for buy-side firms to find ready bids and offers for their secondary

[2] ICMA, 2014, 'The current state and future evolution of the European investment grade corporate bond secondary market: perspectives from the market'

market interests, while banks reduce the risk and capital they are willing to commit to market-making and the liquidity they are happy (or able) to provide. While the study's respondents acknowledge that extraordinary monetary policy and a benign interest rate and credit risk environment also play a role in reducing the incentive for banks to apply capital to market-making activities, it is largely regulatory impacts, not least the increased cost of capital, that are driving the reduction in secondary market liquidity. Respondents further highlight the additional risks to the market-making model presented by the MiFID II/R pre- and post-trade transparency obligations and the provision under CSDR for mandatory buy-ins (the latter is discussed in more detail in Example 3).

Subsequent studies have only served to corroborate the conclusions and justify the concerns of the ICMA study. While conceding that there are a variety of complex interactions affecting the changing role of market-making on the robustness of core financial markets, a paper by the BIS Committee on the Global Financial System[3] recognizes that reduced balance sheet capacity is leading to banks in many jurisdictions reducing inventories in less liquid assets, such as corporate bonds.

Earlier this year, the International Council of Securities Associations (ICSA) consolidated seven studies, by eleven member associations, highlighting the general decline in bond market liquidity across a number of global jurisdictions[4]. Among these, several observations stand out. According to a study by PwC[5], as a result of changes in capital and liquidity regulation, '(c)apital and funding intensive areas such as market making in fixed income, credit, derivatives and commodities have been particularly impacted, adding that '(t)his is consistent with our finding of a decline in the number of market makers active in the European corporate bond markets.' A paper by the Association Française des Marchés Financiers (AMAFI)[6] states that '(t)he secondary sovereign and corporate bond markets operate almost entirely as a result of market makers' and concludes that 'it is vital that the European version of the capital adequacy rules laid out by the Basel Committee does not lead to greater restrictions on market making activity.'

Work by the Bank of England[7] and the International Monetary Fund[8], amongst others, further add to the growing weight of research highlighting deteriorating liquidity conditions in European bond markets, which can largely be attributed to the increasing capital costs and regulatory challenges facing the traditional market-making model.

A number of potential market solutions to help "re-liquefy" European corporate bond markets have been widely discussed, including the development of electronic trading and greater "standardization" of corporate bond issuance. However, as the ICMA study discusses, both of these initiatives provide limited scope with respect to "creating" liquidity. In the case of electronic trading, there is certainly scope for platforms and various protocols to help source or aggregate market interests, but trading platforms do not in themselves generate interests. In the worst case, a proliferation of different platforms and trading venues could in fact threaten to fragment liquidity.

[3] BIS, 2014, 'Market-making and proprietary trading: industry trends, drivers and policy implications', CGFS Papers, No 52
[4] ICSA, 2015, 'Bond market liquidity: key issues'
[5] PwC, 2015, 'Global financial markets liquidity study'
[6] AMAFI, 2015, 'Tenue de marche: Un enjue pour des marches efficacies au service du financement de l'economie'`
[7] Baranova et al, 2015, 'Has corporate bond market liquidity fallen?', bankunderground.co.uk
[8] IMF, 2015, Global Financial Stability Report, Chapter 2, 'Market liquidity – resilient or fleeting?'

Meanwhile, the suggestion of standardization of corporate bond features (in particular maturities and coupon dates) and greater 'benchmarking' (tapping a few standardized issues, rather than issuing new lines of bonds) is contentious, particularly among the issuer community. It should be noted that a number of issuers do already issue benchmark-size bonds to help create an effective issuer "curve", and much work has already been undertaken to standardize and harmonize legal and documentation elements of corporate bonds. In the European market however, it is a limited number of corporate issuers that would be able to support the proposed increased issuance sizes. Critics of the proposal have additionally suggested that a standardized benchmark model of issuance could create additional refinancing risks, as well as potential costs related to managing surplus cash balances. Accordingly, ICMA and its members, not least its corporate issuer constituents, believe that any initiatives related to corporate issuance practices should remain market driven, and not be subject to regulatory intervention.

If you have suggestions to remedy the issue(s) raised in your example, please make them here:

ICMA will continue to work with market users and providers, including banks, broker-dealers, investors and asset managers, intermediaries and trading platform providers, as well as corporate issuers, to try to find ways to 're-liquefy' the European corporate bond secondary markets, and to ensure that they remain functioning and efficient. However, the benefits created by behavioral changes and innovations in market practice and infrastructure can only ever be incremental at best, and it would be unrealistic to think that the liquidity provided to the markets through the market-making model can be replaced. ICMA perceives that it will therefore largely fall on policy makers and regulators to ensure that bond markets remain sufficiently liquid and able to function, and which will almost certainly require the underlying support of the market-making model.

A number of possibilities open to policy makers and regulators to consider include:

- Careful review and analysis of the potential implications and impacts of Basel measures as implemented under CRD IV/R, not least the calibrations of the Net Stable Funding Ratio and the Fundamental Review of the Trading Book, both of which threaten to raise the cost of capital for market-making activity even further.
- Further review of the pre- and post-trade transparency calibrations of MiFID II/R, including exemption and deferral waivers, to reflect more accurately the typical lack of underlying bond market liquidity, particularly during the post-issuance stage.
- Extended deferral of the implementation of mandatory buy-ins under CSDR, or at least until an extensive and transparent market impact assessment has been conducted (see Example 3).
- Measures to improve the liquidity and resilience of the repo market (see Example 2).
- A modification to EMIR to allow for uncovered position of CDS, to help re-liquefy this important hedging market.

Example 2 for Issue 2

Repo market liquidity and collateral fluidity

To which Directive(s) and/or Regulation(s) do you refer in your example? (If applicable, mention also the articles referred to in your example.)

CRD IV [Directive 2013/36/EU] /CRR [Regulation (EU) No 575/2013]; CSDR [Regulation 909/2014]; MiFID II [Directive 2014/65/EU] / MiFIR [Regulation (EU) No 600/2014]**;** SFTR [COM/2014/040]; BRRD [Directive 2014/59/EU]

Please provide us with an executive/succinct summary of your example:

ICMA wishes to underscore that the repo market plays a vital and central role in the modern financial ecosystem, facilitating a number of critical functions and interacting with a variety of different financial markets. Since its early development in the 1970s and 1980s as a means to provide secured short-term funding as a less risky, and so more accessible, alternative to the unsecured deposit market, the repo markets of developed economies have grown significantly, not only in size, but also in terms of sophistication and relative importance. Beyond providing a means for secured short-term borrowing and lending, the repo markets are essential for funding the market-making books of broker-dealers for both sovereign and corporate debt, and so play a key role in underpinning secondary market liquidity for global bond markets (See Example 1). Similarly, repo markets are the glue that binds many derivatives with underlying cash securities, in particular exchange traded bond futures and options. Liquid and efficient derivatives markets are relied upon by both financial and corporate institutions to hedge and disseminate their interest rate exposures. Often overlooked, the repo market is also where collateral is priced, sourced, and mobilized, allowing a whole range of financial and corporate institutions to meet the margining requirements that increasingly underpin today's financial markets. Finally, the repo market is the primary channel through which central banks target bank reserves and transmit monetary policy.

It soon becomes clear that the ability for the repo market to function efficiently and effectively is essential for the overall health of the capital markets through which governments and corporates raise funding and whereby investors and savers can earn returns and capital growth. In many ways, the repo market represents the foundation stone of the financial system that facilitates investment, employment, productivity, and economic growth. To interfere with the repo market is to tamper with the DNA of modern-day capital markets. Yet this is precisely what the confluence of various regulatory initiatives appears to be doing.

Of all the regulatory initiatives that impact repo markets, nothing is having a greater effect than the Leverage Ratio. As a blunt, non-risk weighted capital requirement based on total balance sheet size, this effectively acts as the binding constraint on repo market activity (due to its high volume, low risk, low spread, balance sheet intensive nature), more so than risk capital requirements, to the point where it makes repo, as a traded product, unprofitable. This creates a problem from a repo and collateral liquidity perspective. Liquidity and pricing in repo and collateral markets is reliant on the bank repo desks 'matched-book model'. That is, the ability and willingness of bank repo desks to provide pricing

and liquidity to a broad range of clients for their various, and often highly diverse, liquidity and collateral needs. As taking repo positions onto the balance sheet becomes more capital intensive, as a consequence of the Leverage Ratio, so banks are beginning to retrench from providing repo and collateral liquidity.

The Net Stable Funding Ratio (NSFR) has the potential to increase the costs of trading repo further; requiring additional long-term funding to support what is primarily a short-term market. If NSFR were to be applied at the transaction level, many short-term repo transactions would become economically unviable, something which has been flagged in numerous industry consultation responses and discussions with the Basel Committee. **Over the coming months ICMA intends to conduct more analysis on the potential impacts of NSFR for the European repo market, which it will share with the Commission**. Of particular concern is the limited scope in the EBA report for off-setting interdependent assets and liabilities under the ratio, given the proposed strict limits on the provisions for netting.

Meanwhile, a number of other European regulatory initiatives threaten to add to the risk and costs of transacting repo in Europe, including the treatment of securities financing transactions under BRRD resolution stays, CSDR mandatory buy-ins, SFT-Regulation reporting requirements, and MiFID II/R reporting obligations.

Please provide us with supporting relevant and verifiable empirical evidence for your example: (please give references to concrete examples, reports, literature references, data, etc.)

In 2014, ICMA published the paper *'Collateral is the new cash: the systemic risks of inhibiting collateral fluidity'*, which addressed growing concerns related to the potential for systemic collateral demand-supply imbalances as a result of regulation. The report concluded that while the demand and supply of collateral is inherently dynamic, and so cannot be predicted, demand-supply imbalances should not be a threat, even under stressed scenarios, so long as the ability for collateral to move through the system (i.e. 'collateral fluidity') is not inhibited.

The paper noted that collateral fluidity requires both robust and efficient settlement infrastructure (the 'plumbing'), as well as bank funding desks that are able to source, price, manage, and mobilize collateral (the 'pump'). It highlighted the potential risks arising from existing and proposed regulation (including CRD IV/R Leverage Ratio and NSFR, CSDR mandatory buy-ins, SFT reporting, mandatory hair-cuts, mandatory clearing, collateral ('re-')use restrictions, and the Financial Transaction Tax) that would limit the ability of bank repo desks to provide liquidity to the repo market and so support collateral fluidity, particularly under stressed conditions.

In November 2015, ICMA published the paper *'Perspectives from the eye of the storm: the current state and future evolution of the European repo market'*[9], which illustrates how regulation is already dramatically impacting the way in which repo desks are able and willing to provide repo market liquidity, primarily in response to the new regulatory framework.

This study, based on extensive interviews with market participants (including bank repo desks, buy-side users of the market, both leveraged and 'real money', inter-dealer brokers, trading platform providers,

[9] ICMA, 2015, 'Perspectives from the eye of the storm: the current state and future evolution of the European repo market'

triparty agents, agent lenders, and central clearing houses), reveals that that the European repo market is undergoing a transformation on an unprecedented scale, driven primarily by banking and market regulation, in particular Basel III. As a direct consequence of the Leverage Ratio, as well as other capital and liquidity measures, repo, as an on-balance sheet product, is becoming expensive to the point where it is no longer tradable. A raft of other regulatory initiatives, such as BRRD, SFTR, CSDR, and MiFID II/R, all contain elements that add yet another layer of risk and cost to repo transactions.

In terms of market structure, this is driving two key outcomes. Firstly, most banks have already restructured their repo business models or are in the process of doing so. Key trends include de-risking, deleveraging, transformation from a profit-centre to a cost-centre, reducing head-count, and the merging of repo desks with other funding functions to create centralized liquidity and collateral management hubs. Secondly, as banks adapt to the new capital and liquidity requirements, and refocus their business models to take less risk while optimizing returns on scarce balance sheet, so their relationship with their clients is also being recalibrated. As banks focus more on their own capital and liquidity requirements, ahead of their clients' financing needs, so this is driving closer, more symbiotic bank-client interactions in the search for mutual funding solutions. The downside to this is that buy-side users of the repo market can no longer rely on readily available liquidity and pricing, and, in some circumstances, may find that the funding door is closed to them. This lack of ready short-term liquidity in the repo market further poses risks to central counterparty clearing houses (CCPs) that rely on the repo market for the safe and efficient management of margin. As mandatory clearing is introduced for more products and markets, a less liquid repo market becomes a substantive risk to the CCP model.

The study concludes that while predicting the future evolution of the European repo market is difficult, since it is predicated on too many unknowns arising from both regulation and monetary policy, there are a number of consensus views. These include an expected reduction in the size of the market, an increase in the diversity of participants, a general widening of bid-ask spreads, and the ongoing merging of banks' funding and collateral management functions. However, the overriding concern among market participants is that in the future, although they expect the repo market to continue in some form, it may be unable to function as effectively and efficiently as it has in the past in providing liquidity and collateral fluidity to the financial system. This has potential negative consequences both for markets and the broader global economy.

If you have suggestions to remedy the issue(s) raised in your example, please make them here:

As described, and illustrated by the ICMA studies referenced, the primary limitation on the ability of bank repo desks to provide repo and collateral market liquidity is the direct result of the Basel III measures being implemented through CRD IV/R, in particular the Leverage Ratio and NSFR. The Commission should review how both initiatives are applied. Under Leverage Ratio, more scope for balance sheet netting of securities financing transactions would help to mitigate much of the negative impact, while for NSFR, besides again relaxing the netting constraints, also redressing the proposed asymmetry in match-funding short-term borrowing and lending with financial institutions would seem to be a logical and positive enhancement.

Other potential considerations to mitigate negative liquidity and efficiency impacts for the repo and collateral markets include:

- Increased scope under NSFR to allow for the application of netting, or off-setting, of interdependent assets and liabilities, in particular in the context of intermediated 'matched' repo and securities lending transactions and inventory financing.
- More focused and less onerous reporting requirements under SFTR, that are also broadly consistent with other SFT reporting initiatives, would not only minimize costs and disincentives for repo market liquidity providers and consumers, but would also provide scalability and efficiency for the authorities who are expected to compile, process, and interpret the data.
- Repo and other securities financing transactions should be removed from pre- and post-trade transparency requirements under MiFID II/R, as well as transaction reporting and best execution obligations, on the grounds that this provides no useful purpose.
- Resolution stays should be subject to the maintenance of payments (as in fact stated in BRRD Article 71) and it should not be possible to override this using powers to invoke payment suspensions (under BRRD Article 69). Furthermore, there should be symmetry of treatment for cleared and non-cleared transactions.
- Extended deferral of the implementation of mandatory buy-ins under CSDR , or at the very least maximizing the term of SFTs for which the near-leg of SFTs are exempted under the regulation, so as to avoid dis-incentivizing longer-term financing transactions (see Example 3).

Example 3 for Issue 2

CSDR mandatory buy-ins and fixed income liquidity

To which Directive(s) and/or Regulation(s) do you refer in your example? (If applicable, mention also the articles referred to in your example.)

CSDR [Regulation 909/2014] Article 7

Please provide us with an executive/succinct summary of your example:

While committed to the spirit of the CSDR and supportive of constructive initiatives to improve settlement efficiency and safety in the European capital markets, ICMA, throughout, has advocated against the introduction of mandatory buy-ins. ICMA maintains that a mandatory buy-in regime, as opposed to a discretionary buy-in regime, would not only be extremely challenging to design and implement, but would have adverse impacts on liquidity and pricing in the European bond markets (both sovereign and corporate), as well as securities financing markets. This would not only be an additional cost and an increase in market risk borne by investors, but would in turn increase the costs and risks for both sovereign and corporate issuers. At a time when deteriorating liquidity conditions are becoming an increasing concern for a number of national and international regulatory bodies, exacerbated by the extraordinary monetary policy measures of many central banks, the introduction of mandatory buy-ins will only serve to compound the challenges faced by the European capital markets and beyond. Furthermore, mandatory buy-ins, rather than improving settlement efficiency, will, by impairing both bond market and securities financing liquidity, deliver the counterproductive result of worsening it.

ICMA's primary objection to the implementation of a mandatory buy-in regime is based on two considerations:

(i) The regulation is inherently flawed, both in principle and detail.

(ii) Moving from a 'best-efforts' settlement regime to a 'guaranteed delivery' regime will have significant negative implications for offer-side liquidity in instruments that rely on the market-making model to provide market liquidity.

The flaws in the level 1 regulation have been well documented by ICMA and others, both in the various CSDR consultation responses, but also in discussions with the Commission and ESMA. These can be summarized as:

i. The 'buy-in' is not defined, nor is the purpose of the buy-in explained.

ii. The buy-in process seems to apply to CSD participants, which in most instances will not be the same as the trading counterparties to the transaction. This creates market risk for, and places trading responsibility on, non-trading entities.

iii. The provision for the payment of the price differential between the buy-in price and the original transaction price is reversed, compared to standard buy-in processes.

iv. The payment of the cash compensation differential (and, implicitly, the buy-in price differential) can only be paid in one direction (from the delivering party to the receiving

party), which creates a perverse economic and risk asymmetry in the CSDR version of a 'buy-in'.

v. The regulation seems to apply to trading counterparties that are subject to the regulation of a non-EU jurisdiction. This extraterritorial scope raises questions of enforceability.

In essence, what the regulation appears to do is misconstrue what a buy-in is, and what it seeks to do. The right to issue a buy-in, which already exists in the non-cleared European fixed income markets, is a contractual remedy available to failed-to, receiving counterparties to ensure delivery of the securities while restoring both trading counterparties to the economic position they would have been in had the transaction settled. CSDR seems to reconstruct this contractual remedy as a penalty for failing counterparties by creating an additional, unquantifiable market risk element to the sale of securities, particularly where this is a short-sale (as in the case of market-makers).

In July 2014, ICMA published a paper, *'Buy-ins, how they work, and the challenge of CSDR'*[10]. The paper, through examples, explains the construct and dynamics of buy-ins, as they are currently applied in the European fixed income markets. It then examines the proposed buy-in structures under CSDR, both from the Level 1 text, and the (then) proposed Level 2 operations put forward by ESMA, highlighting the risks arising from the Level 1 flaws.

However, while ICMA appreciates that much has been done by ESMA in the meantime in relation to the level 2 RTS to minimize the potential risks, costs, and inconsistencies of the regulation, the regulation still remains highly problematic as a result of the level 1 flaws. Firstly, the unaddressed asymmetry in the direction of the cash payment of the buy-in or cash compensation differential is fundamentally flawed and renders this aspect of the regulation unfit for purpose. Secondly, even if this was to be redressed, it does not resolve the negative impact that mandatory buy-ins (as opposed to discretionary buy-ins) will have on bond and repo market pricing and liquidity.

Please provide us with supporting relevant and verifiable empirical evidence for your example: (please give references to concrete examples, reports, literature references, data, etc.)

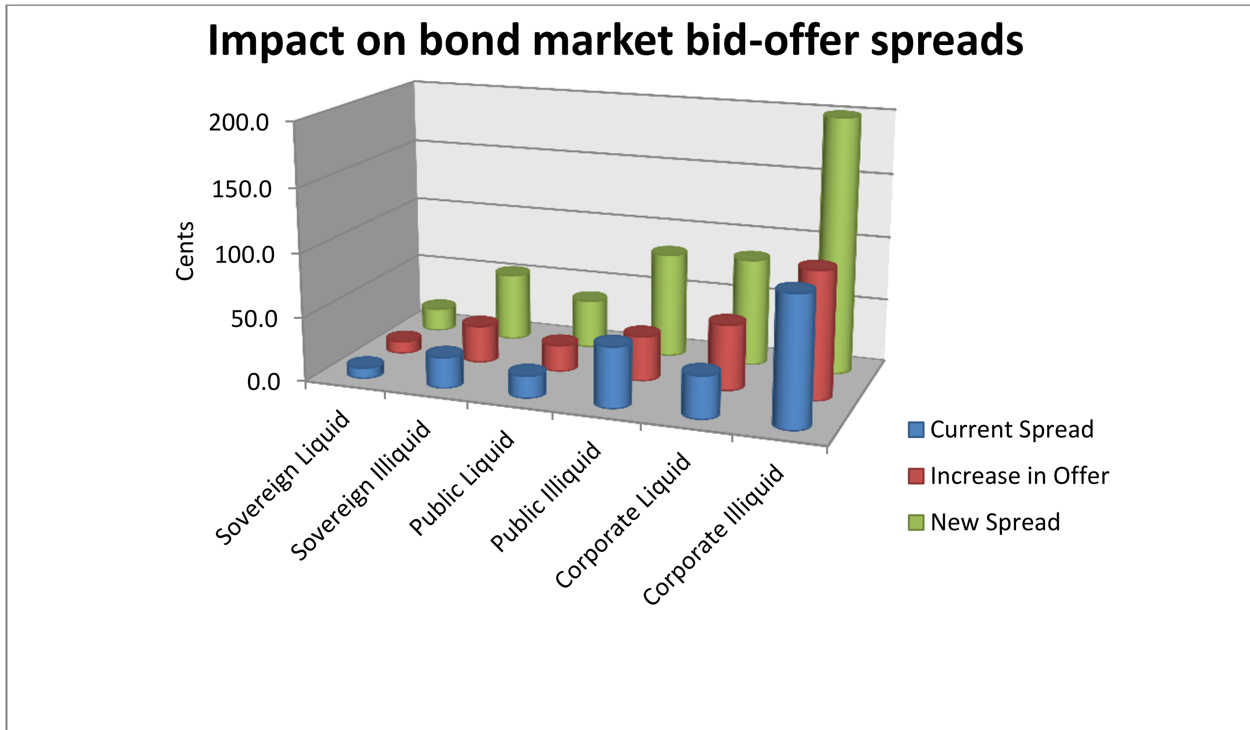
In February 2015, ICMA, published a market impact study for CSDR mandatory buy-ins.[11] Based on the proposed framework for mandatory buy-ins under the regulation, including the proposed calibrations for 'liquid' and 'illiquid' securities, European fixed-income market-makers (disaggregated by three broad asset classes: sovereign bonds, public bonds, and corporate bonds), were asked to provide data on their current average bid-ask spreads, and how these would be adjusted under the mandatory buy-in regime. Repo traders were asked to provide similar data, based on a one-month repo quote (again disaggregated by asset class).

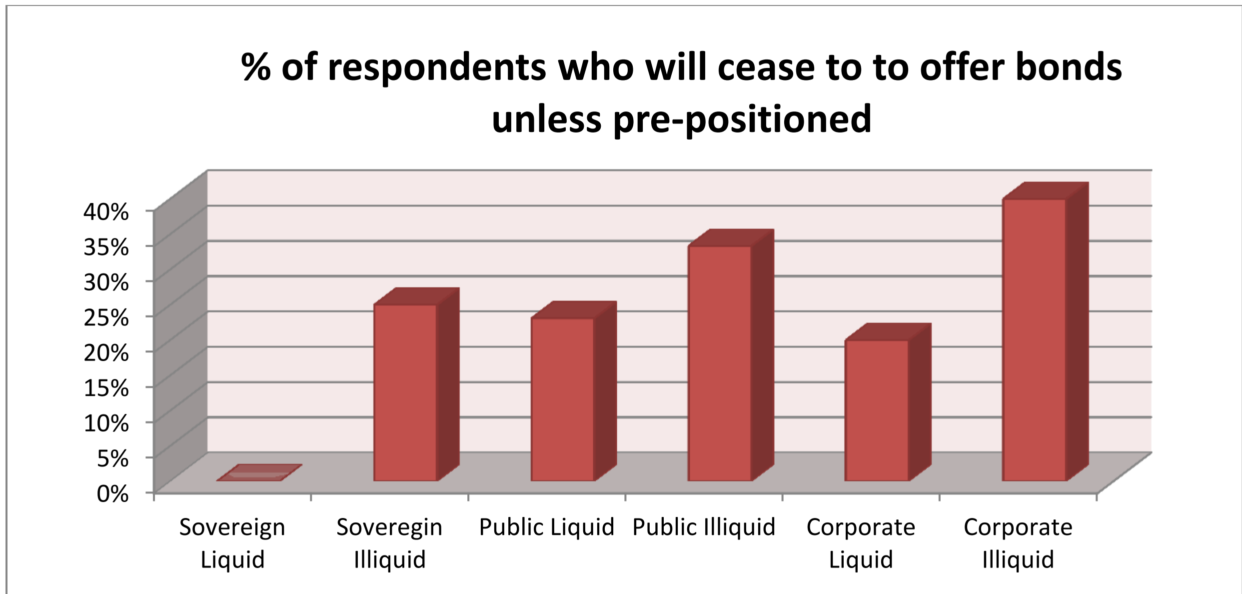
This study illustrates that under the mandatory buy-in regime, liquidity across secondary European bond and financing markets will reduce significantly, while bid-offer spreads will widen dramatically. The

[10] ICMA, 2014, 'Buy-ins, how they work, and the challenge of CSDR'
[11] ICMA, 2014, 'ICMA Impact study for CSDR mandatory buy-ins'

results suggest that even the most liquid sovereign bonds will see bid-offer spreads double, while secondary markets in less liquid corporate bonds may effectively close. The survey further suggests that for many less liquid bonds, including sovereign and public issues, market-makers will retrench from providing liquidity altogether. The results further suggest that these outcomes will be broadly similar for the repo market.

The below figures summarize the results of the study.





Impact on 1 month repo bid-offer spreads

Basis Points

120.0
100.0
80.0
60.0
40.0
20.0
0.0

Sovereign Liquid
Sovereign Illiquid
Public Liquid
Public Illiquid
Corporate Liquid
Corporate Illiquid

Current Spread
Increase in Offer
New Spread

A further impact study conducted by the European CSD Association (ECSDA)[12], also in February 2015, highlights the practical implications and sheer administrative challenge of implementing a mandatory buy-in regime. Based on settlement efficiency data from 11 EU CSDs in November 2014, ECSDA estimates that over 150,000 buy-ins would have been initiated that month (based on the proposed level 2 RTS), for a total value of around EUR 214 billion. In other words, each business day, more than 7,500 buy-ins would have been triggered for a value of EUR 10.7 billion on average. Assuming that November 2014 figures are broadly representative of a typical month, the total number of buy-ins initiated each year could thus reach over 1.8 million, representing a total value of more than EUR 2.5 trillion. Even if the eventual number of buy-ins were significantly smaller than this, it is clear to see that the number of buy-ins being issued and executed at anytime would be more than enough to cause meaningful market disruption and to impede the efficiency and smooth operation of Europe's secondary capital markets.

If you have suggestions to remedy the issue(s) raised in your example, please make them here:

- The implementaion of CSDR mandatory buy-ins should be further deferred, at least until an extensive and transparent market impact assessment has been conducted, involving a broad range of market participants and stakeholders.
- If mandatory buy-ins are to be implemented, at the very least the asymmetry for payments in the regulation (Articles 7(6) and &(7)) should be addressed to allow for payments to flow in both directions, depending on the original transaction price and the subsequent buy-in or cash compensation reference price. Without doing so, this element of the regulation is not fit for purpose.

[12] ECSDA, 2015, 'ECSDA Comments on the upcoming CSDR technical standards and technical advice on settlement discipline'