# Implementing CSDR mandatory buy-ins *By Andy Hill*

The mandatory buy-in obligations being introduced under the EU CSD-Regulation (CSDR) are unique in that, while market regulation usually seeks to reduce overall systemic risk, this particular regulatory initiative is purposefully designed to increase risk. The intention is to improve settlement discipline by disincentivising settlement fails, effectively transitioning "best effort" delivery markets closer to a "guaranteed delivery" regime. Mandatory buy-ins will apply from September 2020 (although this is now expected to be delayed until November 2020).

## The obligation to buy in

The Regulation aims to improve settlement discipline by making it compulsory for purchasing parties to initiate a buy-in process against a seller who fails to deliver securities in a timely manner. It is important to note that this legal obligation to buy in a failing counterparty applies directly to the purchasing entity, which in many cases will be the end-investor (such as an asset manager or a pension fund), and not to the custodian bank, settlement agent, or any other intermediary in the settlement chain. The regime also affords little flexibility. Purchasing parties must initiate the buy-in process once a trade has failed for four business days in the case of liquid equities, or seven business days in the case of all other securities (including bonds).[1] Furthermore, the buy-in must be completed (ie initiated, executed, and settled) again within four or seven business days, depending on the underlying security. In the event that the buy-in cannot be executed,[2] the original trade must be cancelled, and a prescribed cash compensation process is triggered.[3]

## Scope

Since the Regulation applies to transactions intended to settle on an EU/EEA regulated CSD or ICSD, the extra-territorial scope is likely to be significant. The regulatory technical standards (RTS) provide that all parties in the settlement chain must have contractual arrangements in place that not only require the relevant counterparties to comply with the regulatory obligations of the buy-in, but that also ensure that the Regulation is enforceable in all relevant jurisdictions.[4] Thus an asset manager located in Singapore or New York, settling trades on an European ICSD, will still be required to buy in a failing counterparty, whoever and wherever they may be.

## Applying the ICMA buy-in rules

Buy-in mechanisms in the non-centrally cleared markets are nothing new. Participants in the international bond markets have relied upon the ICMA buy-in rules[5] for decades. The ICMA buy-in rules, however, are a contractual right, not a mandatory obligation, and are designed to protect parties to a transaction in the event of a settlement fail, rather than to penalise them. ICMA intends that its rules can continue to play a protective role with the introduction of CSDR mandatory buy-ins, providing not only a legal framework and market best practice for its implementation, but also mitigating some of the risks created by the new regime.

First, it is hoped that trading under the ICMA Rules will remove an anomaly that otherwise exists in the regulatory provisions relating to the differential payments that need to be made between parties following the execution of the buy-in or the application of the cash compensation process. As a result of an apparent error in the Level 1 Regulation, which has the payments being made in the wrong direction, an attempt to correct this in the RTS only goes part of the way, allowing for the differential payment to go in the right direction (from seller to buyer) in the case that the buy-in price or cash compensation reference price is higher than

1. The time between the intended settlement date and the legal requirement to initiate the buy-in process is known as the "extension period"

2. The Regulation allows for the purchasing party on more attempt at the buy-in process (called the "deferral period") before cash compensation becomes obligatory

3. The amount of cash compensation payable is based off a determined market reference price for the underlying security, although it can also be determined by a pre-agreed formula

4. See Article 25 of the RTS

5. The ICMA buy-in rules are part of the ICMA Secondary Market Rules and Recommendations which apply automatically between ICMA members transacting in international securities (ie a security intended to be traded on an international, cross-border basis and capable of settlement through an international central securities depository or its equivalent.

the original transaction price, but not being made at all in the case that it is lower. From a seller's perspective, this is the economic equivalent of being short an at-the-money put option in the event of a settlement fail.[6] The ICMA rules, as now, intend to allow for payments to be made in either direction.

Second, while the Regulation does not preclude it, there is no provision for a "pass-on" mechanism. The ICMA buy-in rules allow for pass-ons, which facilitate the possibility for a single buy-in to settle an entire chain[7] of failing transactions. Apart from being extremely efficient, this also avoids the undesirable situation of multiple buy-ins being executed at the same time, with important implications for market volatility and stability. Further advantages of the ICMA pass-on mechanism are that it is both (I)CSD and intended settlement date agnostic, and there is no requirement to have overall visibility of the transaction chain. While preserving this degree of efficiency and flexibility may prove challenging under CSDR, it is hoped that a modified version of the ICMA pass-on mechanism will still be available through the ICMA buy-in rules under the Regulation.

ICMA is in discussion with ESMA on these issues and more (such as the requirement to appoint a buy-in agent) and once there is greater clarity on what may or may not be possible under the new buy-in regime, ICMA will launch a consultation of members and other stakeholders to revise its buy-in rules to align with, and support implementation of, the CSDR requirements. This is likely to be in the second half of 2019.

## Is there a case for mandatory buy-ins?

While ICMA concentrates on updating its buy-in rules to support implementation and provide best practice for applying the CSDR buy-in requirements in the international bond markets, it will continue to raise the question with the European Commission and other official sector stakeholders as to whether the CSDR mandatory buy-ins should even be implemented in the non-cleared markets. Apart from the cost and logistical complexity associated with implementation and enforcement (eg the extra-territorial implications), it is not obvious that there is a case for it. Settlement efficiency data would suggest that fails, at least in the European bond markets, affect a relatively small subset of overall transactions, are usually the result of operational inefficiencies, and, in most cases, clear up after a few days. In the case of longer-term fails, the causes tend to be more structural and due to a lack of liquidity in the underlying security. As the increased cost of capital forces market makers to trim inventories, and as repo traders scale back intermediation, sourcing liquidity in bond markets, particularly for credit and emerging markets, has become more challenging. In many cases buy sides are reliant on market makers' willingness to sell short in order to get the liquidity they need. Furthermore, transactions are delivery-versus-payment (meaning purchasers still have the use of their cash until the transaction settles) and purchasers retain the full economic benefit of ownership of the securities, even while the transaction is unsettled;[8] so in this respect investors are not disadvantaged. Ironically, they might be in the case of compulsory cash compensation.

ICMA has long advocated alternative, more market-friendly initiatives to improve and maintain settlement efficiency, such as a more appropriate (and flexible) calibration of the cash penalty regime.[9] In many respects, the mandatory buy-in regime is a bit like using a sledgehammer to crack a nut.

## Who loses under mandatory buy-ins?

Unsurprisingly, the biggest impact of the CSDR buy-in regime is likely to be a significant reduction in secondary market liquidity, particularly for less liquid markets such as credit and emerging markets, a cost that will be borne most directly by investors. A 2015 ICMA impact study[10] suggests that, with the introduction of mandatory buy-ins, bid-ask spreads will widen significantly, even for the most liquid sovereign bonds, while in the case of less liquid corporate bonds market-makers will retreat from showing offers in securities that they do not already hold.

Ultimately, this expected loss of liquidity is likely to feed through to the cost of issuance, impacting sovereigns as well as corporates. In the case of smaller, less frequent issuers, it may be a barrier to accessing the capital markets altogether. As is frequently pointed out to the European Commission, this is hardly in keeping with a key objective of Capital Markets Union.

More about both CSDR mandatory buy-ins and the ICMA buy-in rules can be found on the ICMA website.

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6. Ordinarily a buy-in seeks to maintain the original economics of the transaction; in the case od CSDR buy-ins, in many circumstances, the economics will be inadvertently and unpredictably altered.

7. That is, where counterparties having matching purchases and sales

8. Although they will have a credit exposure to the selling party during this time

9. CSDR will also introduce cash penalties for settlement fails in parallel to the mandatory buy-in regime

10. ICMA *Impact Study for CSDR Mandatory Buy-ins*, February 2015