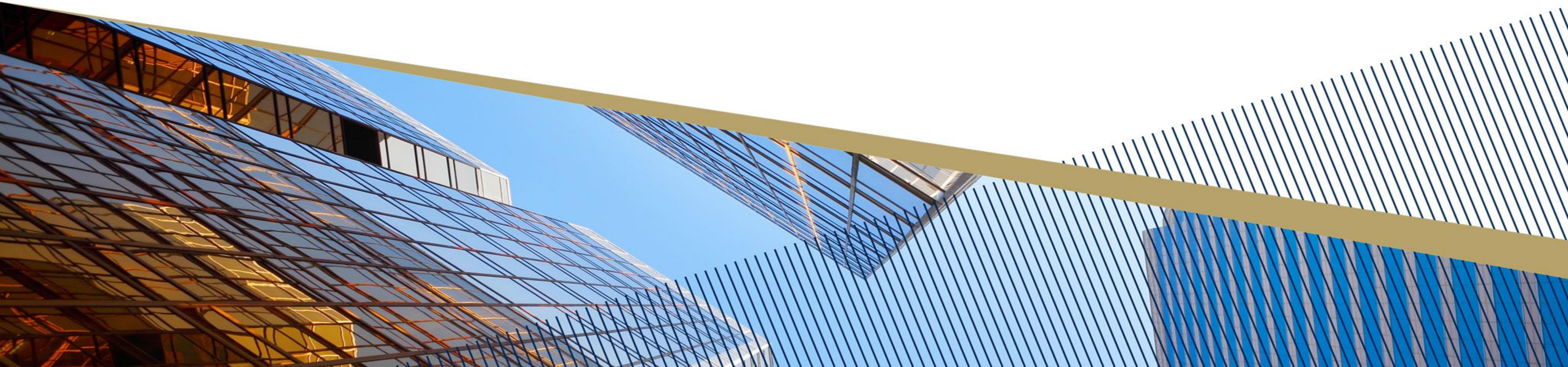
CSDR Buy-ins: designing a pass-on mechanism

Industry workshop

London, July 1st 2019



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1. Recap: Buy-ins & Pass-ons
2. What defines a transaction chain
3. ICMA buy-in rules: current pass-on mechanism
4. Provisions of CSDR
5. Proposal to ESMA for multi-ISD pass-ons
6. Discussion: challenges for implementing a pass-on mechanism under CSDR
7. Alternative pass-on mechanisms?
8. Next steps

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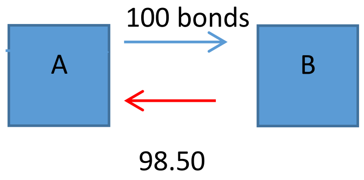
What is a buy-in?

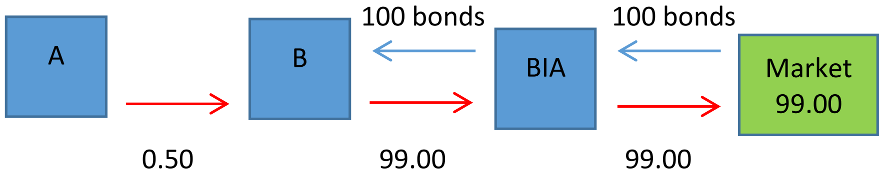
- Buy-ins generally apply to failing cash transactions and not to SFTs.
- In the event of a settlement fail, a buy-in mechanisms provide a buyer of securities the contractual right to source the securities elsewhere (usually for guaranteed delivery), cancel the original trade, and settle between the 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 was executed by a buy-in agent: an independent 3rd party appointed by the non-defaulting party. However, this requirement was removed from the ICMA Buy-in Rules in 2017 following a market consultation.
- A 'pass-on' mechanism allows for a single buy-in to be passed along a chain of linked failing transactions.

How do buy-ins work?

Original trade

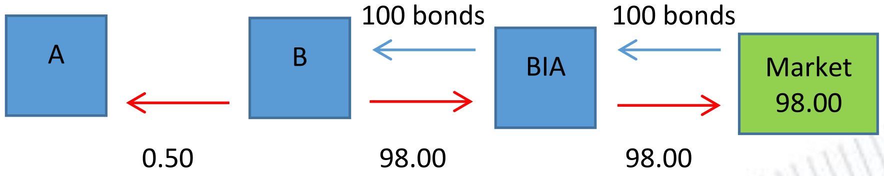


Buy-in at a higher price



	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

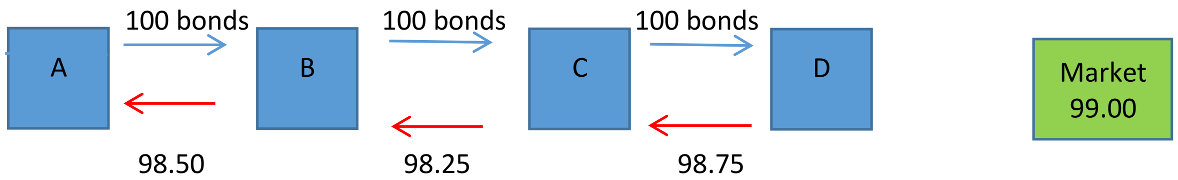


	A	B
P&L before buy-in	+0.50	(0.50)
P&L after buy-in	0.50	(0.50)
P&L impact of buy-in	0	0

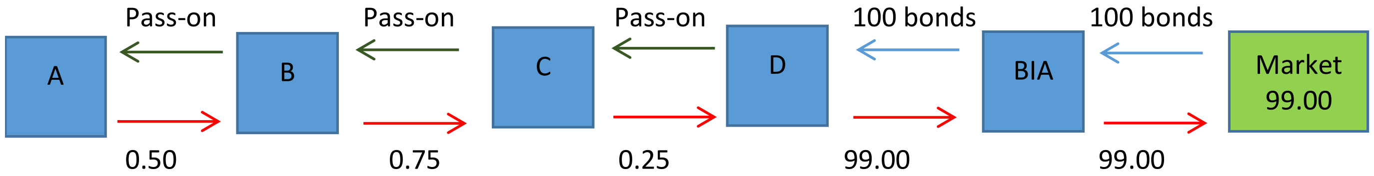
How do 'pass-ons' work?

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

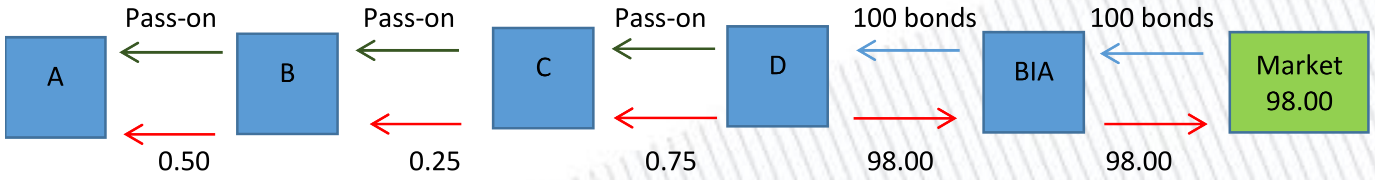


Buy-in with pass-on



	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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Transaction chains for the purpose of buy-ins/pass-ons

- A purchase and a sale with different counterparties
- Same security (ISIN)
- Same nominal value (or purchase ≤ sale)
- Same buy-in rules apply
- CSD agnostic
- Intended settlement date (ISD) agnostic

- **Should intended settlement dates (ISD) be the same?**
  - Liquidity considerations
  - Market volatility / stability
  - Sale before purchase (short-selling)

Note that even with multiple-ISD models, any failed-to party in the chain can elect to initiate a buy-in at their discretion (ie passing-on the right to buy-in is completely optional)

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ICMA Secondary Market Rules & Recommendations

- The SMR&Rs apply to all transactions concluded by members as buyer or seller in international securities.
- An **international security** is a security intended to be traded on an international, cross border basis (i.e. between parties in different countries), and capable of settlement through an international central securities depository or equivalent.
- When a transaction is subject to the rules of an exchange, its rules shall apply.
- Nothing in the SMR&Rs shall be construed as discharging members from complying with applicable local laws and regulations when concluding a transaction.
- Unless otherwise stated, the SMR&Rs do not apply to the syndication and allotment process or to repurchase and to other transactions entered into under the GMRA or similar master agreements.
- The SMR&Rs are usually included in the contractual terms of business between ICMA members.

The ICMA Buy-in Rules will be revised to provide a contractual framework to support compliance with CSDR and providing best practice for its implementation.

ICMA Buy-in Rules: pass-ons

- A pass-on situation exists where the seller is in turn a buyer of all or part of a corresponding amount of securities from a third party and passes on a buy-in notice in respect of those securities to that third party.
- When a pass-on situation exists, a buy-in notice shall be issued **immediately** upon receipt of the previous buy-in notice.
- When a pass-on situation exists, the following wording shall be added to the buy-in notice: *This is a pass-on situation*
- Where a pass-on situation exists, a copy of the buy-in execution confirmation must be passed through the entire chain to the final defaulting member as evidence of close-out proceedings. The price at which the buy-in is executed will apply equally to all transactions closed-out.
- **One execution will satisfy the total chain.**

Note that overall visibility of the chain is not necessary

Challenges

- Ensuring that the pass-on notice is passed along the chain in a timely manner (“immediately”)
- Ensuring that the eventual buy-in details are passed along the chain **immediately**

These take on more resonance with very long chains and/or with chains across multiple time-zones

- More scope for final bought-in party to contest ‘off-market’ buy-in price since removed from initiating party

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CSDR

- There is no provision for a pass-on mechanism in CSDR or the RTS. However, Recital 34 of the RTS states:

Parties involved in the buy-in process could also limit the number of buy-ins by coordinating their actions amongst themselves, and informing the CSD thereof, where a transaction is part of a chain of transactions and may result in different settlement instructions.

- ESMA has confirmed that they see this as a mandate for a pass-on mechanism and have encouraged the industry to provide proposals/outlines of how this could work.

- The assumption is that the general buy-in provisions (and timings) of CSDR would still apply.

Agenda

Proposal

The proposal has been drafted with input and support from a broad range of ICMA member representation, including fixed income traders and operational experts. It is generally considered an optimal design with regards to:

(i) Market stability (it minimizes the potential number of buy-ins triggered by a single failing transaction)
(ii) Market risk (it minimizes the potential risk faced by intermediaries in a transaction chain)
(iii) Workability (it largely emulates an existing, well established, and widely used pass-on mechanism)

It is also designed to address the key recognized challenges to a pass-on mechanism presented by CSDR.

Challenges to a pass-on mechanism under CSDR

For a buy-in mechanism to work efficient and effectively, and with a high degree of reliability, there are two main pre-requisites:

(i) There is no incentive for any party in the chain, other than the final purchaser, to initiate a buy-in process
Since parties in a chain are not economically disadvantaged by the pass-on process, there is no incentive for them to start a buy-in process; rather it is easier to rely on the final purchaser to start the process and wait for the pass-on. *

(ii) There is no requirement for any party in the chain, other than the final purchaser, to initiate a buy-in process
This is important since often the transactions in a chain will not be for the same value date. The discretionary nature of the buy-in process means that parties in the chain will not be obligated to start a buy-in process, and so the discretion to do so will ultimately fall to the final party in the chain (the final purchaser).

* This will largely be addressed by “fixing” the asymmetry in the differential payments

The obligation for parties in a chain to buy-in: working within the mandatory requirement

- Since CSDR requires that a buy-in process be initiated immediately following the extension period, this gives rise to the risk that each new ISD in a transaction chain will trigger its own buy-in process, leading to multiple buy-ins. This proposal therefore seeks to address this particular challenge by proposing that **the obligation to initiate the buy-in passes along a transaction chain until it reaches the final purchaser**.

The obligation would only pass along the chain in the case that:
(i) The matching purchase and sale are in the same security
(ii) The matching purchase and sale are for the same nominal amount*
(iii) The matching purchase and sale are within the extension period

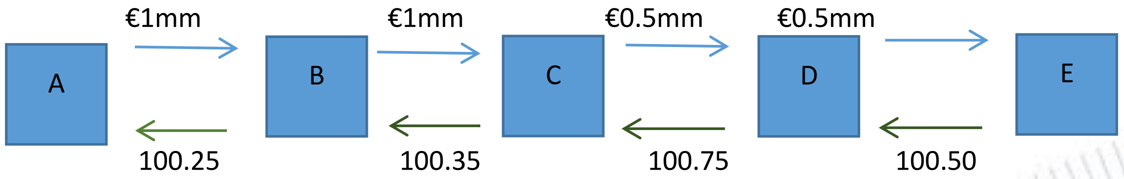
- It is also important to remember that while the pass-on mechanism potentially extends the chain (and so the overall extension period) with each new ISD, cash penalties will continue to apply, so putting increasing pressure on the ultimate failing party (the start of the chain) to settle their trade before the buy-in process is started.

* The pass-on will be based on the sale nominal, to the extent that the sale nominal is ≤ purchase nominal

Example

This scenario involves 4 transactions in the same security and 5 different counterparties:

- Transaction 1: On Trade Date (TD) January 2 2019, Party B buys €1,000,000 nominal of XYZ 1% 1/2024 from Party A at a price of 100.25, for settlement date (ISD) January 4 2019 (T+2)
- Transaction 2: TD January 2 2019, Party B sells €1,000,000 nominal of XYZ 1% 1/2024 to Party C at a price of 100.35, ISD January 7 2019 (T+3)
- Transaction 3: TD January 8 2019, Party C sells €500,000 nominal of XYZ 1% 1/2024 to Party D at a price of 100.75, ISD January 10 2019 (T+2)
- Transaction 4: TD January 9 2019, Party D sells €500,000 nominal of XYZ 1% 1/2024 to Party E at a price of 100.50, ISD January 11 2019 (T+2)



TD:	1/02	1/02	1/08	1/09
ISD:	**1/04**	**1/07**	**1/10**	**1/11**

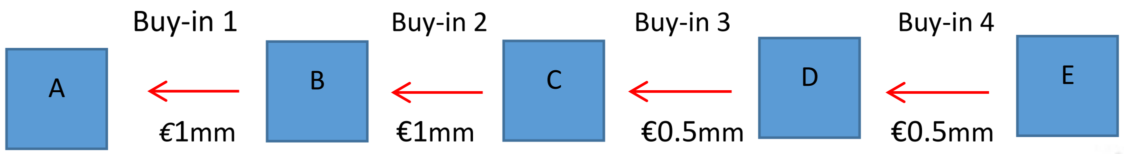
We will assume that A fails to deliver the €1mm securities to B on ISD 1/04 and continues to fail. In turn this causes: B to fail its delivery of €1mm to C on 1/07; C to fail its delivery of €0.5mm to D on 1/10; and D to fail its delivery of €0.5mm to E on 1/14.

Example

No pass-on mechanism

In the case of there being no pass-on mechanism, each transaction could potentially trigger a buy-in process:

- On 1/15, B is required to initiate the buy-in process against A (to be completed by 1/23) for €1mm
- On 1/16, C is required to initiate the buy-in process against B (to be completed by 1/24) for €1mm
- On 1/21, D is required to initiate the buy-in process against C (to be completed by 1/29) for €0.5mm
- On 1/22, E is required to initiate the buy-in process against D (to be completed by 1/30) for €0.5mm



Notice date:	**1/15**	**1/16**	**1/21**	**1/22**
Completion date:	1/23	1/24	1/29	1/30

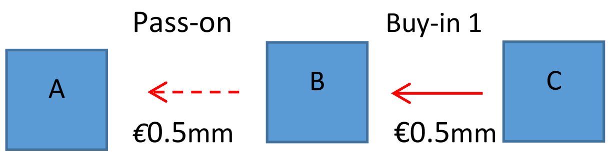
<u>Summary</u>: 4 buy-ins initiated over 6 days for a total nominal value of €3mm

Example

Proposed pass-on mechanism

- On 1/15, B is not required to initiate the buy-in process against A, since it has a matching sale to C (also for €1mm) within the extension period (ISD 1/07)
- On 1/16, C is required to initiate a buy-in process against B, but only for €0.5mm, since it has a part-matching sale to D (of €0.5mm) also within the extension period (ISD 1/10)
- On 1/18, D is not required to initiate the buy-in process against C, since it has a matching sale to E (€0.5mm) within the extension period (ISD 1/11)
- On 1/21, E is required to initiate the buy-in process against D, for €0.5mm, since it has no matching onward sale

Buy-in 1: C issues a buy-in against B for €0.5mm, and B passes-on to A

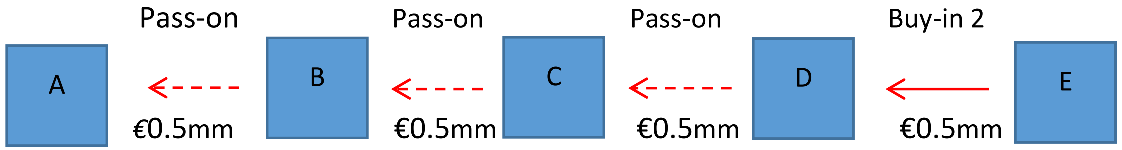


Notice date:	**1/16**	**1/16**
Completion date:	1/24	1/24

Example

Proposed pass-on mechanism

Buy-in 2: E issues a buy-in against D for €0.5mm, D passes-on to C, C passes-on to B, B passes-no to A



Notice date:	**1/22**	**1/22**	**1/22**	**1/22**
Completion date:	1/30	1/30	1/22	1/30

<u>Summary</u>: 2 buy-ins initiated over 5 days for a total nominal value of €1mm

Pros & cons

Pros:

- Does not require overall visibility of the transaction chain
- Is not CSD specific (can work across multiple CSDs)
- Could work across other jurisdictions (where mandatory buy-ins do not apply)
- Works for different ISDs in the transaction chain (to the extent that each matching buy and sell in the chain fall within their respective extension period)
- Is based on a well-established and widely used mechanism in the non-cleared bond markets
- Avoids additional risks (and potential costs) for all parties in the chain, except for the original failing seller
- Will also work in the case of cash compensation
- Will reduce the overall number of buy-ins and increase market efficiency
- Where parties sell short, they will still be incentivized to cover their position within the extension period
- While the overall buy-in extension period of the chain is potentially extended, cash penalties will still apply, maintaining (and even increasing) the incentive for settlement discipline

Cons:

- Each link in the transaction chain potentially extends the time between the original fail and the eventual buy-in (although only in the case of long-sales as opposed to ‘short-sales’)
- To work successfully, all parties in the chain must pass-on the original notification and eventual buy-in execution details immediately [this challenge exists today]

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Challenges & operational considerations

- Identifying/defining the transaction chain (visibility required?)
- Split transactions
- Breaking the transaction chain:
  - Out-of-scope SFTs
  - CCPs
  - Transactions on out-of-scope CSDs
- Evidencing / reporting a pass-on situation
- Ensuring the pass-on eventually takes place
- Communications along the chain
- Partial buy-ins / pass-ons
- Managing volume of potential buy-ins/pass-ons (automation?)
- Buy-side considerations (usually end of the chain?)

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Alternative pass-on mechanisms

- Same ISD
- Different mechanisms for different markets (bonds v equities / liquid vs illiquid)
- Hybrid model
- Other options?

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Conclusions and next steps