

ICMA CSDR-SD Working Group Workstream on Best Practice for Cash Compensation

Call: March 17, 2020

Meeting notes

The ICMA CSDR-SD Cash Compensation Workstream was created with a view to establishing trader-led market best practice for the cash compensation process under the CSDR mandatory buy-in provisions. The workstream is intended to constitute primarily fixed income traders and business drivers.

This was the third 'meeting' of the group, and was conducted exclusively by call, due to the current Covid-19 situation.

- The ICMA Secretariat recapped the previous discussions where a strong view had emerged that the cash compensation process was inherently part of the overall buy-in process, and that the focus of the workstream needed to be on both.
- Members discussed the concept of this essentially being a four-stage process: (i) the counterparty selling securities on the premise that they would be able to source or borrow them; (ii) being unable to source them, the purchasing party appointing a buy-in agent to source them; (iii) with the buy-in agent being unable to source the bonds through their franchise and networks, opening up the search to a much wider universe of potential holders (potentially via a reverse-auction process; (iv) in the absence of any actionable offer, deriving a cash compensation reference price by other means.
- The question was raised as to whether there should be any distinction between steps (ii) and (iii) in this process, given that the traditional role of the market-maker acting as a buy-in agent had already become largely defunct. The reason for an ongoing settlement fail was due to a lack of liquidity: the value of any buy-in process should therefore be to increase liquidity.
- It was asked if there was still some value for smaller participants in them using market-makers as buy-in agents, given their potentially wider franchises. It was countered that smaller firms would already be reaching out to their larger peers and counterparts ahead of the buy-in being triggered, and that a functioning buy-in process would add value to the entire market. There was a need to think 'outside of the box': just as CSDR would force a change in trading behaviour, so it would be necessary to rethink how buy-ins can be executed successfully.
- It was suggested that one advantage of using established market-makers as buy-in agents is that they can offer switches to holders of the bonds being bought-in. There would be a natural reluctance for holders to sell out of securities, simply because they were being bought-in and were bid at a premium. Being able to extract value through replacing them with alternative, similar bonds might not only be what persuades them to sell, but could also help to achieve best execution from the perspective of the party being bought-in. The counter argument was that while this was a valid point, it would be highly unlikely that any market-makers would be naturally axed to provide such switches.

- It was stressed that while this workstream was focused on the cash compensation process, this should be as much about avoiding trades going to cash compensation. One of the failings of the CSDR mandatory buy-in process is that it would result relatively quickly in an outcome that would be highly undesirable for both parties.
- It was suggested that so long as there was a meaningful possibility of a trade resulting in cash compensation, dealers would not be willing to show offers. However, it was noted that the unpredictability of the cash compensation reference price was no more than that of a buy-in price. In both cases, the price could be at a significant premium to fair market value, which is ultimately the risk (and cost) to the selling party.
- It was asked whether there could be some form of pre-determined fallback valuation at the time of trading, which would at least give the seller some comfort of their maximum downside. However, it was noted that it would be practically impossible to know what the reference price could or should be at the time of trading. Again, any losses incurred by the trader would be as a result of the difference between the reference price and where they have the position marked on their books at that point in time, with the original trade price being irrelevant. This was based on the assumption that the asymmetry in the payment process could be corrected (which otherwise would create even greater unpredictability of potential losses).
- While it was noted that designing a functioning, value-added buy-in process would be a critical consideration, and that avoiding reaching cash compensation should be the primary objective, there was still a regulatory requirement to establish a cash compensation reference price in the event that a buy-in is unsuccessful, and that the regulatory provisions were not adequate for this purpose. Therefore, there was still a need for the market to reach a consensus on a 'least bad' process for providing a reference price, that could be relatively transparent and broadly consistent. While the eventual cash compensation reference price could never be predictable, it was perhaps important that at least the methodology for deriving it was.
- It was suggested that a composite of various vendor valuations could be a potential starting point. This may also help to address any skew that could be built into an individual valuation price.
- It was questioned whether any valuation price would be skewed higher as a result of the unsuccessful buy-in auction and the footprint of a 'distressed buyer' in the market. However, it was noted that this was equally true of any successful buy-in price, which would always be at a premium to 'fair value'.
- It was asked whether a composite price provided by vendors would fall under the scope of European Benchmark Regulation (BMR). The group felt that most likely it would not, given that it would only be used in specific situations (the cash settlement of one-off bilateral trades) and, given that it was not being used to form an actual transaction in itself, it would not be public. It was felt that it may be worth a discussion with the regulators at some point, but the priority should be to establish something that worked for the market first.
- The question of licensing and access to vendor valuations was flagged as a potential barrier.

- In terms of moving the workstream forward, it was suggested that the group split into two sub-streams:
 - ❖ One focused on *rethinking* the buy-in process, and developing something that could achieve the objective of increasing liquidity.
 - ❖ One focused on establishing a transparent methodology for determining a cash compensation reference price in the worst-case scenario of an unsuccessful buy-in.
- It was noted that it would be important to include the right constituents in these discussions: in particular greater trader/business engagement was key, and in the case of the reference price discussions, including relevant vendors/data providers.
- It was proposed that despite an earlier suggestion of rolling this workstream into ICMA's market and legal workstream focused on updating the ICMA Buy-in Rules, there would probably need to be more work undertaken on the buy-in and cash compensation processes first.