European Commission Targeted consultation on the review of the Regulation on improving securities settlement in the European Union and on central securities depositories

ICMA Detailed Response (February 2021)

Executive summary of the response

- ICMA's response is focused primarily on Settlement Discipline, and from the perspective of non-cleared bond and repo markets.
- Buy-ins, whether regulatory or contractual, should be discretionary and not mandatory. Mandating buy-ins will have adverse impacts for European bond market efficiency and liquidity. The response presents quantitative analysis to illustrate the scale of the costs that market participants (particularly investors) are likely to incur.
- Analysis using settlement efficiency data illustrates not only how extensive and disruptive a mandatory buy-in regime would be for European bond markets under normal conditions, but that the procyclical impacts during the March-April 2020 COVID-19 market turmoil could have been catastrophic.
- In its response, ICMA presents a 'waterfall' of proposals for implementing the Settlement Discipline regime, based on members' assessment of what is most optimal in terms of minimizing disruption to the orderly functioning of Europe's bonds markets, while still attaining the objective of improved settlement efficiency. The suggested, alternative options can be summarized as:
  (i) implement cash penalties, but not regulatory buy-ins (the need for and design of a regulatory buy-in regime should be subject to a robust market impact assessment); or
  (ii) mandate that all EU investment firms have in place contractual frameworks to remedy fails; or
  (iii) implement regulatory buy-ins as a last resort but with a number of critical revisions to the current framework.
- If buy-ins are to remain part of CSDR, this will require a number of revisions, including: (i) symmetrical payments for the buy-in and cash compensation differential; (ii) the introduction of a pass-on mechanism; (iii) greater flexibility in the requirement to appoint a buy-in agent; (iv) a clarification (and narrowing) of scope; (v) a more workable cash settlement ('cash compensation') mechanism for illiquid bonds; (vi) more tailored timelines for completing the buy-in; and (vii) guaranteed delivery for the buy-in process.
- ICMA's members are concerned about the current implementation schedule for the buy-in regime, the timetable for any revisions, and the resulting costs and disruptions to the industry of introducing changes midflight. They strongly believe that the buy-in regime should accordingly be delayed.

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Introduction

On whose behalf ICMA is responding

The International Capital Market Association (ICMA) welcomes the opportunity to provide feedback on the European Commission's Targeted Consultation Document on the review of CSDR ('the Consultation').

ICMA is a membership association, headquartered in Switzerland, committed to serving the needs of its wide range of members in promoting resilient well-functioning international and globally coherent cross-border debt securities markets. Members include private and public sector issuers, financial intermediaries, asset managers and other investors, capital market infrastructure providers, central banks, law firms, and others worldwide. ICMA currently has around 600 members located in over 60 countries.[1]

This feedback is provided on behalf of ICMA and its relevant constituencies, in particular those representing secondary bond markets (the Secondary Market Practices Committee - SMPC), the repo market (European Repo and Collateral Council - ERCC), and the investor community (the Asset Management and Investors Council - AMIC). The response was drafted and consolidated by a dedicated CSDR-Settlement Discipline Working Group (the CSDR-SD WG), consisting of sell-side and buy-side traders (bonds and repo), operations experts, as well as legal, compliance, and regulatory policy representatives, including those from relevant trading venues and other market infrastructures. In total, 96 different firms are represented in the CSDR-SD WG, covering the EU and beyond.

The focus of ICMA's response

ICMA is responding to the Consultation purely from the perspective of Settlement Discipline (Section 7). This is because the Settlement Discipline (SD) provisions have a direct impact on market functioning and, in the case of mandatory buy-ins, should be considered market regulation, not post-trade regulation. Accordingly, ICMA's response is formulated very much through a markets lens and is driven by considerations of market efficiency, liquidity, stability, and resilience. It is also fully aligned with the European Commission's objective of enhancing the depth and liquidity of financial markets to promote economic growth and ensure financial and fiscal stability.[2]

It is important to note that ICMA's response is only from the perspective of bond and repo markets, given that ICMA's remit covers cross-border debt securities markets. ICMA does not seek to speak for equity or other non-bond markets, which may have different perspectives and requirements. Furthermore, ICMA's response is largely limited to the application of buy-ins in non-centrally cleared markets.

[1] See: www.icmagroup.org. ICMA's transparency register number is 0223480577-59.
[2] European Commission, *The European economic and financial system: fostering openness, strength and resilience*, January 2021

Timing for Settlement Discipline implementation

ICMA's members very much welcome this review of CSDR and the opportunity to make constructive (and necessary) revisions to the mandatory buy-in provisions, and this forms the substance of ICMA's response and recommendations. However, it is important to stress that the industry has grave concerns not only with respect to the design of the framework itself, but also the implications of the timing of this review process with the respect to the current implementation schedule.

As the Commission will be aware, the implementation of the mandatory buy-in framework is a significant undertaking for the entire financial market, not only in Europe, but globally. This involves far reaching contractual papering and remediation,[3] covering numerous markets and jurisdictions, in line with the requirements set out in Article 25 of the RTS. Furthermore, investment firms need to develop processes and infrastructures in order to comply with the regulatory requirements and provisions, with the associated resources and investment this requires. The Commission will also be aware that in order to ensure compliance by the scheduled go-live date of February 2022, much of this work and investment is already well underway, but continues to be frustrated by lack of much needed regulatory guidance on key issues. Accordingly, some implementation efforts, particularly those related to the extensive contractual work required, have necessarily been put on hold.

The industry's concerns relate not so much to the significant investment and allocation of resources required both to meet the extensive requirements of Article 25 of the RTS and to build the necessary architecture and workflows to support the new regime (although this in itself is a challenge in light of the lack of critical implementation guidance still required).[4] Rather the concerns are due to the fact that the industry does not know if or when any amendments to the CSDR provisions will be passed into law (noting that some revisions are probably essential), and what impact this will have on current implementation preparation. At best it will mean that much of this ongoing effort and investment is redundant; and at worst it will mean repeating it.

Creating such a level of uncertainty around an implementation project of this scale and reach cannot be viewed as beneficial to the industry or in any way helpful to the development of the EU's financial markets. Doing so at a time when investment firms and infrastructures are already stretched by the impacts of the COVID-19 pandemic and Brexit only adds to the immense pressure that the industry is under.

ICMA and its members believe that in light of this necessary review, to avoid increased uncertainty and **in the interests of supporting stable financial markets, the European Commission and ESMA should take immediate steps to suspend the implementation of the mandatory buy-in provisions until after (i) subsequent revisions arising from the review process are passed into law and (ii) adequate time for the industry to implement the finalized provisions**. This should not affect the implementation of other aspects of the SD regime, including cash penalties. It would also be consistent with the arguments

[3] For markets where contractual buy-in remedies or the equivalent already exist, such as for bonds or SFTs, these contracts will need to be revised to accommodate the regulatory requirements, as outlined in RTS Article 25.

[4] Open implementation issues include the ability for firms to settle the buy-in or cash compensation symmetrically, the ability to apply a pass-on mechanism, the inability to find a buy-in agent, the inability to derive a cash compensation reference price, as well as significant ambiguity around scope.

recommending a re-assessment of regulatory buy-ins while the cash penalty regime is monitored and, if required, recalibrated.

Beyond the significant costs and disruption that the industry would face as a result of implementing changes to the CSDR buy-in framework after the go-live date, ICMA's members would also point to the long-lasting, and potentially irreparable, damage that implementing the current buy-in provisions could inflict on the European bond markets, even if the regime, in its current form, were only to be in force for a limited period of time. A less risky and far more robust and efficient approach would be to make the required revisions to the CSDR buy-in regime before attempting implementation.

Overview of ICMA's position on Settlement Discipline

ICMA and its members are fully supportive of initiatives to improve and maintain settlement efficiency in the European bond markets. While settlement efficiency rates are already relatively high for bonds, particularly sovereign bonds, ICMA recognizes that there is always room for improvement. This is one of the objectives of the work being undertaken by ICMA's ERCC Operations Working Group to improve intra-day liquidity in the T2S settlement system and in developing market best practice for partialing settlements and transaction shaping. It is also recognized, however, that many settlement fails are the direct result of the EU's fragmented network of settlement and clearing systems, and where more work could be done to improve standardization and interoperability.

What ICMA presents is essentially a 'waterfall' of proposals for implementing the Settlement Discipline regime, based on members' assessment of what is most optimal in terms of minimizing disruption to the orderly functioning of Europe's bonds markets, while still attaining the objective of improved settlement efficiency. The suggested, *alternative* options can be summarized as: (i) implement cash penalties, but not regulatory buy-ins; (ii) mandate that all EU investment firms have in place contractual frameworks to remedy fails; or (iii) implement regulatory buy-ins as a last resort but with a number of critical revisions to the current framework.

Option 1: Implement cash penalties

ICMA and its members further support regulatory initiatives to impose settlement discipline, particularly in markets where settlement practices and operational efficiencies may not be optimal. ICMA is therefore supportive, at least in principle, of the CSDR provisions for cash penalties. By way of example, the introduction by the Treasury Market Practices Group (TMPG) in May 2009 of a fails charge in the US Treasury market proved highly successful in restoring settlement efficiency in response to a concerning increase in settlement fails (partly driven by a sharp decline in short-term interest rates).[5] The penalty rate applied (effectively 300bp annualized) is based on quantitative analysis of settlement rate sensitivity under different interest rate scenarios, and is therefore calibrated dynamically[6] to optimize the disincentive to failing a transaction in US Treasuries.

[5] See Garbade, K.D., et al, 2010, 'The Introduction of the TMPG Fails Charge for US treasury Securities', Federal Reserve Bank of New York, FRNBY Economic Review, October 2010
[6] The penalty is a spread (300bp) to the Fed Funds rate

ICMA therefore recommends that the European Commission proceed with the implementation of cash penalties as currently provided in the regulation, and as scheduled. A suitable period for observation and assessment of impacts on both settlement efficiency rates (relative to specified targets) and market impacts (including changes in pricing and liquidity) should be allowed. Following this period, and informed by quantitative and qualitative analysis, the penalty rates applied to different asset classes may need to be recalibrated in order to achieve the (presumed) intended outcome of ensuring high rates of settlement efficiency whilst avoiding undermining market liquidity.

Re-assess regulatory buy-ins

Whilst the cash penalty regime is implemented, monitored, assessed, and recalibrated as necessary, ICMA and its members are strongly opposed to the implementation of a regulatory buy-in regime. ICMA firmly believes that before a regulatory buy-in regime is introduced, a thorough and extensive impact analysis is required to assess the likely impacts on market functioning, stability, and liquidity across various asset classes and market segments, as well as the expected outcomes in terms of settlement efficiency. This analysis should also be viewed in the context of impacts and outcomes of alternative initiatives to improve settlement efficiency (such as cash penalties). Such an assessment would help to inform the European Commission and co-legislators, firstly, whether a regulatory buy-in regime is justifiable, or even required, and, secondly, in the event that it is felt warranted, what the appropriate design of that regime should be.

ICMA would also point out that **buy-ins are not a post-trade process. They are a market transaction, executed between trading entities, entailing market risk.** As such, any regulatory framework governing buy-ins should be a part of market regulation: which in this case would be MiFIR. CSDR is not the appropriate regulation through which to impose a buy-in regime or to regulate buy-in processes.[7]

Option 2: Contractual buy-ins

ICMA and its members fully recognize the importance of buy-in mechanisms as a risk management tool available to investment firms and which provide them with the right to remedy, at their discretion, settlement fails in relevant transactions. Such a contractual buy-in remedy has been enshrined in ICMA's [Secondary Market Rules and Recommendations] (the 'ICMA Buy-in Rules') for several decades, and is widely relied upon by participants in the international non-cleared bond markets. Similar remedies for settlement fails exist in the contractual frameworks governing securities financing transactions (such as the GMRA and GMSLA).[8] What these contractual remedies have in common is that they provide a right to the non-failing party, and not an obligation. They are also appropriately calibrated for use in the relevant market sector. This is very important in reinforcing their function as a risk mitigant, as opposed to a risk amplifier.

If the European Commission and co-legislators believe that buy-ins are an essential risk management tool that helps to underpin settlement discipline, then one consideration could be to mandate, through the appropriate regulation, that all EU investment firms have in place contractual buy-ins (or similar,

[7] This perhaps reflects a broader problem of regulations being drafted in 'silos' without adequate horizontal transparency and coordination.
[8] Note that buy-ins, as used in the case of outright transactions (and envisaged in CSDR), are generally not applied in the case of SFTs. The GMRA and GMSLA, for example, provide a more appropriate, economically equivalent remedy (known as a 'mini close-out').

appropriate remedies to address settlement fails) with their relevant counterparties. Such remedies should comply with a number of defined, high level principles, that could be outlined in a delegated act. These principles are likely to include: (i) the contractual right for the failed-to party to initiate a buy-in (or similar, appropriate remedy) at their discretion; (ii) the ability to recover reasonable costs incurred in executing the process; (iii) ensuring that the non-failing party is restored to the equivalent economic position that they would have been had the original trade settled; and (iv) providing for a cash settlement alternative (in the case that the securities cannot be replaced). However, this would probably need to be outlined in the RTS, with careful consideration given to the relevant scope of products and transaction types.

Importantly, any regulation should not seek to be overly prescriptive in terms of buy-in processes, and that, as now, different markets should be able to utilize or develop their own frameworks that are best suited to the underlying securities and market structures, but that comply with the basic principles.

While ICMA would strongly argue against a regulatory requirement for the non-failing party to initiate a buy-in process within a certain timeframe, and that in many cases this would not be in the best interests of the non-failing party, or their clients, it could still be possible to legislate for this in the case of contractual buy-ins. However, as will be explained in the response to Question 34.1, establishing the appropriate ‘extension period’, by the end of which the buy-in process must be initiated, cannot be arbitrary. Rather, this requires careful quantitative analysis, based on different asset classes and market segments, in order to optimize the fine balance between improving settlement efficiency and maintaining market liquidity.

Option 3: Regulatory buy-ins

ICMA and its members would argue that imposing a prescriptive, regulatory, one-size-fits-all, buy-in framework on the market (even through the appropriate regulation) is sub-optimal: not only from an industry-wide implementation perspective, but more importantly in terms of the likely outcomes and market impacts. This is already apparent from the number of outstanding requests for clarification with respect to the existing regulatory framework, and which seems to be acknowledged in the questions posed in this consultation.

ICMA would again refer the Commission and the co-legislators to its overarching position that the cash penalty regime should be implemented, while a rigorous impact assessment of a regulatory buy-in regime be undertaken in order to determine (i) if it is necessary and, if so, (ii) what should be the appropriate design of any buy-in regime. However, if that is not a possibility, then as a last resort the existing provisions will require substantive revision before implementation should be attempted. It is important to note that this will almost certainly require changes to the ‘Level 1’ regulation as well as to the ‘Level 2’ RTS.

These required revisions are outlined and discussed in more detail in the responses to Question 34.1 of the Consultation, but include: (i) symmetrical payments for the buy-in and cash compensation differential; (ii) the introduction of a pass-on mechanism; (iii) greater flexibility in the requirement to appoint a buy-in agent; (iv) a clarification (and narrowing) of scope; (v) a more workable cash settlement (‘cash compensation’) mechanism for illiquid securities; (vi) more tailored timelines for completing the buy-in; and (vii) guaranteed delivery for the buy-in process.

Importantly, once again ICMA would argue strongly that even in the case of a regulatory buy-in process, the initiation of the buy-in should be at the discretion of the non-failing party, and that there should be no obligation or timeline within which this should happen. At a minimum, any extension periods will need to be recalibrated, based on careful quantitative analysis of the likely market impacts across various asset classes and market segments.

Next steps

ICMA and its members stand ready to follow-up on any of the points raised in this response, including the analysis presented in support of the recommendations. ICMA would also be keen to discuss with the European Commission the suite of ongoing industry initiatives to improve post-trade efficiencies in which ICMA and its members are actively engaged; not only as a consequence of the impending CSDR Settlement Discipline regime, but also as part of the 'T+0 agenda', bringing more processing into the trade date. This includes processes and developments such as trade booking, trade allocation-confirmation-affirmation-and pre-matching, data management, inventory management, third-party tools to support automated bilateral trade acknowledgement, and client outreach to improve issue resolution and adoption of best practices. ICMA and its members are further advocating through the relevant trading and operations fora for settlement best practices, in particular for trade shaping and partialing of settlements, as well as for the escalation and resolution of persistent settlement fails, both in the cleared and non-cleared bond and repo markets.

Importantly, these initiatives, and others, are focused on the primary causes of settlement fails and inefficiencies, which relate to post-trade infrastructure, processes, and best practice, and they are very much intended to enhance market liquidity, not compromise it. A mandatory buy-in regime does not directly address these challenges, and is likely to impact adversely European bond market functioning, liquidity, and, as illustrated by the analysis of the March-April 2020 COVID-19 turmoil, market stability. ICMA and its members firmly believe that it is not in the best interest of Europe's bond markets, or the citizens they serve, to implement the CSDR mandatory buy-in regime. This is the key message of this response.

Response

Question 33: Do you consider that a revision of the settlement discipline regime of CSDR is necessary?

-Yes
-No
-Don't know / no opinion

Question 33.1: If you answered yes to Question 33, please indicate which elements of the settlement discipline regime should be reviewed:
(you may choose more than one options)

- Rules relating to the buy-in
- Rules on penalties
- Rules on the reporting of settlement fails
- Other

Question 34: The Commission has received input from various stakeholders concerning the settlement discipline framework. Please indicate whether you agree (rating from 1 to 5) with the statements below:
1 (disagree) 2 (rather disagree) 3 (neutral) 4 (rather agree) 5 (fully agree) No opinion

Buy-ins should be mandatory	**1**
Buy-ins should be voluntary	**5**
Rules on buy-ins should be differentiated, taking into account different markets, instruments and transaction types	**5**
A pass on mechanism should be introduced	**5**
The rules on the use of buy-in agents should be amended	**5**
The scope of the buy-in regime and the exemptions applicable should be clarified	**5**
The asymmetry in the reimbursement for changes in market prices should be eliminated 5	**5**
The CSDR penalties framework can have procyclical effects	**5**
The penalty rates should be revised	**4**
The penalty regime should not apply to certain types of transactions (e.g. market claims in cash)	**3**

Question 34.1 Please explain your answers to question 34, providing where possible quantitative evidence and concrete examples.

Mandatory vs. Voluntary

The efficient functioning of most secondary bond markets relies on market-makers and other liquidity providers to stand ready to show offers in securities that they do not necessarily hold, and more so in recent years as increased capital costs have made holding trader inventory uneconomic. When market-makers sell short in this way, they will look to borrow the securities in the repo or securities lending market, hedge their interest rate and possibly credit risk, and look to trade out of their position at the earliest practical opportunity (which could be hours, days, weeks, or even months later, depending on liquidity). Of course, there is always the risk of a settlement fail (say if the repo market is thin), which exposes the seller to the potential risk of a buy-in. With a mandatory buy-in regime, the chances of being bought-in increase significantly.

Risks to liquidity providers

When considering the risks to market-makers and other liquidity providers arising from buy-ins, it is important to understand that buy-ins can be extremely costly for the failing seller. This is due to the 'buy-in premium'.[9] As buy-ins are usually executed for guaranteed delivery this tends to come at a premium to normal 'best efforts' market levels. Buy-ins also have a signaling effect, particularly for less liquid securities, with holders of the underlying security temporarily marking-up their offers to capitalize on the fact that there is a 'distressed buyer' in the market. It is this difference, between the buy-in price and the market price immediately following the buy-in, that the bought-in party will incur as a cost when the original transaction is replaced, and they find themselves with a new long position that must be sold or marked-to-market.

The greater the risk of a buy-in, the less inclined market-makers and other liquidity providers will be to sell securities that they are subsequently required to borrow or buy (i.e. they do not hold the securities in inventory at the point of responding to a request for quote). Thus moving from a market structure where buy-ins are infrequent to one where they are inevitable (after seven business days) will have significant negative consequences for market liquidity. For more liquid securities, the seller may simply adjust their offer price to compensate for the estimated risk of a buy-in and the potential cost arising from this.[10] For less liquid securities, where the risk of a settlement fail increases, and the cost of a buy-in is more difficult to predict, dealers are more likely not to show an offer, and possibly retrenching their liquidity provision in certain securities or market segments completely.

[9] Note that the cost of a buy-in to the bought-in party is not related to the difference between the buy-in price and the original transaction price: it is the result of the difference between the buy-in price and the fair market value at the moment the buy-in is executed.

[10] Predicting the cost of a buy-in is extremely difficult, particularly in the case of less liquid securities, where the buy-in premia can become exaggerated.

Risks in lending securities

A similar risk consideration related to lending securities, particularly when the securities are used to cover short sales.[11] In less liquid markets, securities used to cover trading positions are generally loaned on an open basis, meaning that the holders can recall them at short notice (term markets in credit repo vanished along with the introduction of Basel III capital requirements).[12] This is particularly important when the holder sells a security being loaned, since they will need it back to make good the delivery on their sale. In the event that the securities are not returned on time, they face the risk of being bought-in. There are usually provisions under their repo or lending agreements to remedy the failing repo or loan, but contractually these are very different to a buy-in, both in terms of timing and substance. While it may be possible to pass on the cost of a resulting buy-in through the repo or lending termination provisions (which are more akin to a cash settlement process), this cannot be relied upon, particularly when the buy-in price is very different to the market price.

In a market where buy-ins are discretionary, and seldomly reach execution, this risk from lending securities is largely considered to be manageable. CSDR alters that dynamic, and again the likely result will be a change in the pricing of SFTs to reflect this additional risk, or, in the case of less liquid securities, a cessation of lending altogether. In turn, less liquid repo and lending markets further increase risks for market-makers and other liquidity providers when selling securities that they do not hold, reinforcing the negative liquidity impact.

Impacts on pricing and liquidity

In 2019, ICMA undertook a study to ascertain the potential impacts of the CSDR mandatory buy-in regime on liquidity and pricing across a range of fixed income sub-classes.[13] Focusing on three main constituencies (sell-side market-makers, buy-sides, and repo and securities lending desks), the study seeks to quantify the impacts, as well as painting a more qualitative picture of investor expectations.

The study looks at how the CSDR buy-in provisions, **in particular the mandatory element**, are likely to affect the behaviour of market-makers as they take into account the additional economic risks that the regime introduces. Across all bond asset classes, market-makers are required to show offers in securities that they do not necessarily hold on their books (sell-side members have suggested that between 15% and 30% of bond transactions involve a dealer selling a bond that they do not hold in inventory at the moment of execution). In those instances the market-maker will look to borrow the bond to make good on their delivery[14] (until they cover it with an outright purchase), or they will look to buy it in the market immediately following the sale. In either case their ability to settle the trade on the intended settlement date is contingent on the ability to source the bond in a timely manner, either in the repo/lending

[11] This is an indirect consequence of the underlying bonds being in scope of mandatory buy-ins and is not dependent on the whether or not certain SFTs are in scope (in most cases they will not be).
[12] See ICMA, 2017, *The European Credit Repo Market: the cornerstone of corporate bond market liquidity*
[13] This follows a previous impact study undertaken in 2015, prior to the finalization of the RTS.
[14] This is recognized in the Shot Selling Regulation which provides a short-selling exemption to market-makers in sovereign bonds.

market or the outright market (noting that this is further contingent on any purchase or borrow also settling).

While settlement fails for bonds in the EU markets are low (<2%), and even lower by the time that the CSDR buy-in would be triggered (<0.7%), the economic losses arising from a buy-in are significant. Market-makers therefore need to build a 'buffer' into any offer for bonds that they do not hold in inventory to protect themself against any potential losses, based on an assessment of the probability of the transaction failing for the duration of the extension period as well as the potential downside losses from a buy-in (including the cost of the buy-in agent). The less liquid the bond, the greater the buffer (i.e. the more market-makers will need to adjust their offer price). Essentially, dealers will look to pass the estimated additional risk-adjusted costs of the mandatory buy-in regime back to the investors.

The results strongly suggest that even for the most liquid 'core' sovereign segment of the bond markets, bid-ask spreads will need to widen significantly to adjust for the additional risks created by mandatory buy-ins (see Figure 1), while at the less liquid end of the market (corporates and emerging markets), the impact is more binary, with liquidity providers more likely to refrain from showing offer prices (see Figure 2).

The study also confirms that these impacts are largely anticipated by investors, who will be most negatively affected by the regulation. Again, there is a realization that the biggest impact will be at the lower end of the credit spectrum (see Figure 3).

The study surveyed repo and securities lending desks to ascertain the likely impact of mandatory buy-ins on the repo and lending market. The survey responses suggest that, for the most part, lending and repo activity will continue as normal for sovereigns, supranationals, and agencies (SSA). For other sub-classes of bonds, including corporate bonds, the indication is that borrowing securities will become both more expensive and more difficult (see Figure 4).

Figure 1: impact of mandatory buy-ins on bond market pricing [15]

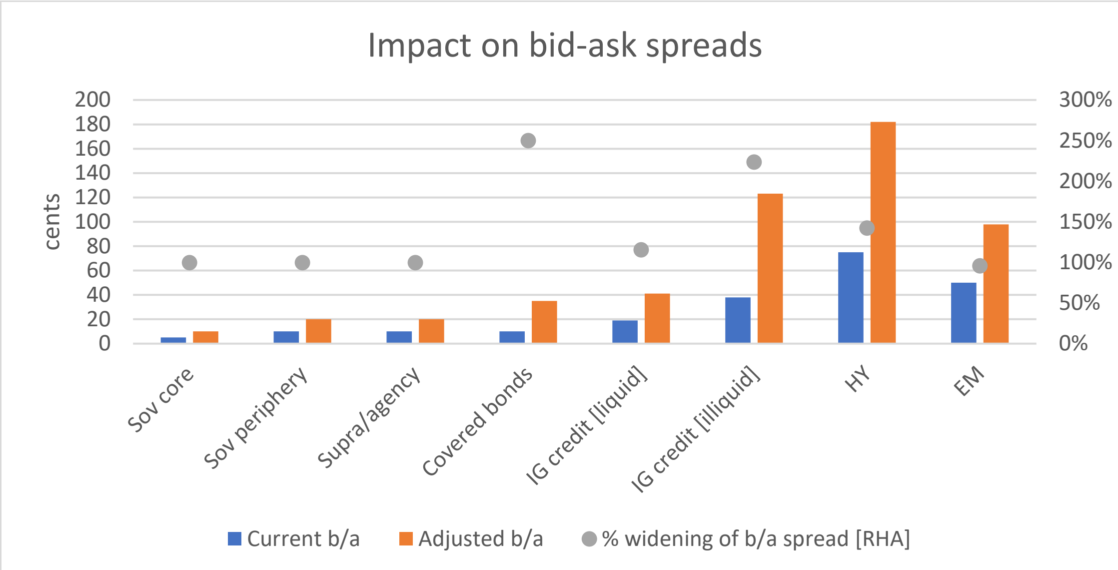
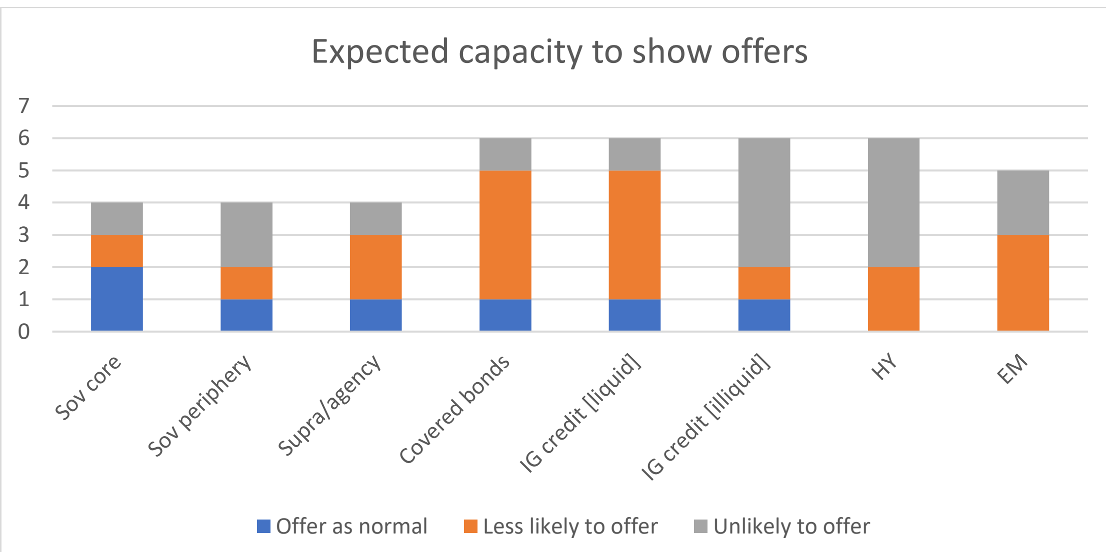


Figure 2: impact of mandatory buy-ins on capacity to show offers



[15] Market-makers were asked to provide their current average bid-ask spread, in cents, based on a 5-year maturity bond across a range of bond sub-classes. Current bid-ask spreads reflect very low probability of being bought-in. They were then asked to provide the average offer-side adjustment they would expect to make for bonds that they did not hold in inventory following the introduction of mandatory buy-ins. This adjustment reflects the increased buy-in risk resulting from the mandatory buy-in provisions.

Figure 3: buy-side expected impact on bond market liquidity

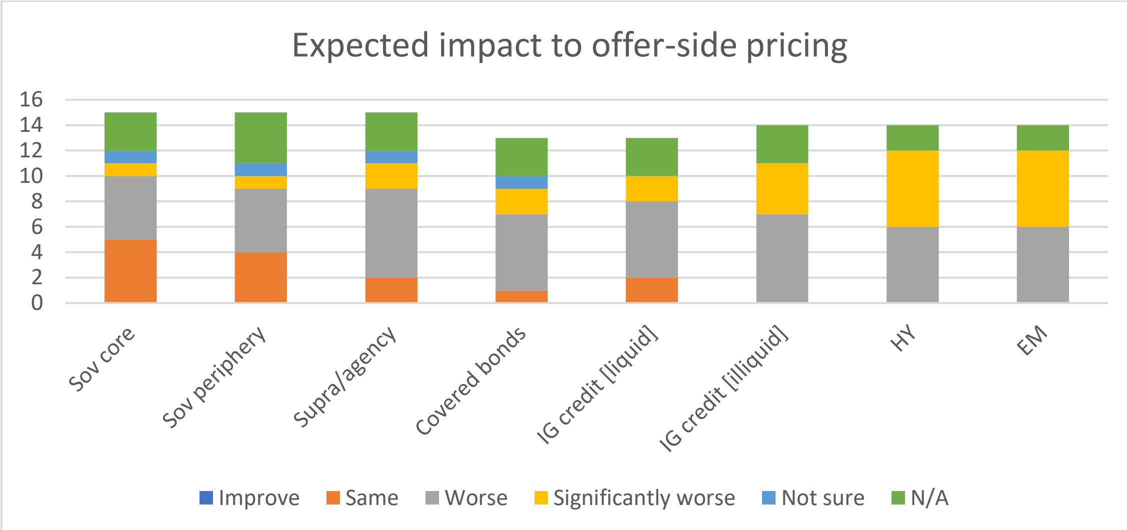
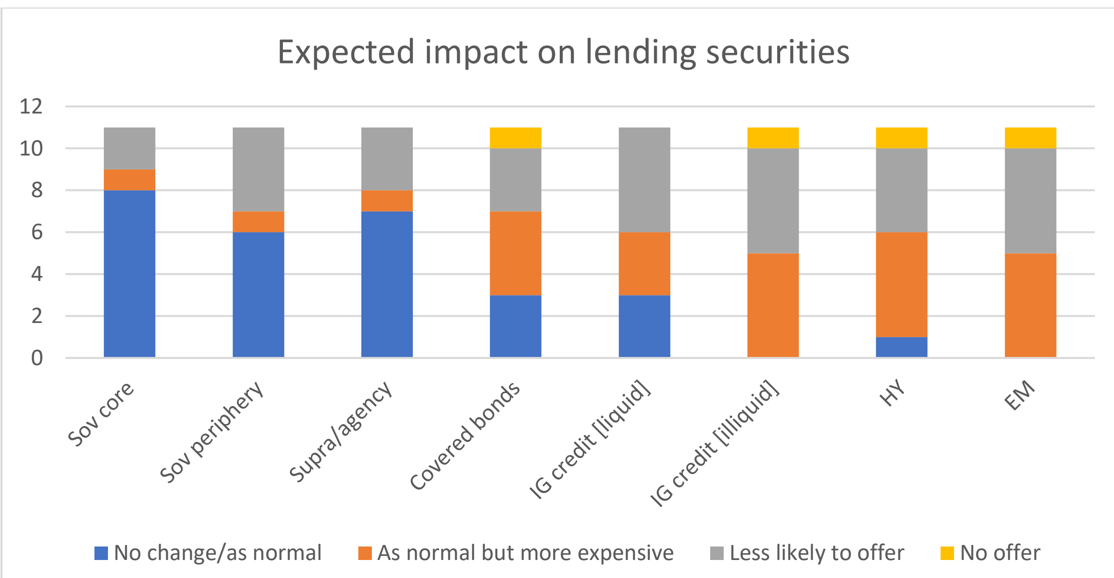


Figure 4: impact on repo and securities lending market for bonds



The full analysis can be found in the report.

Estimating the cost to investors of mandating buy-ins

It is clear that the impact of the CSDR mandatory buy-in regime will be a worsening of secondary market pricing to investors for many of their dealer quotes, as well as more difficulty in finding quotes, particularly in less liquid market segments.

Trying to quantify what this will mean for investors in terms of actual cost is not straightforward, since the impact is likely to be more visible in the form of behavioural change, rather than a predictable price adjustment. If dealers feel that the potential downside of showing an offer to a client is too high, they will simply not show an offer. Similarly, if investors feel that a dealer's price is too high, they will not trade.

To get a sense of the scale of the impact, one approach is to take the price adjustments predicted in the ICMA study and apply these price adjustments to the actual volume of transactions where the settlement is failing on ISD+7 (i.e. trades where a buy-in would have been triggered).

The following analysis does this for non-financial corporates (NFCs), based on the volume of fails at ISD+7 from settlement data provided by Euroclear Bank (covering the period January through August 2020).[16] The average fails rate at ISD+7 for NFCs over this period is 1.41%. This comes to 49,892 different settlement instructions, with a total value of €60,763,879,051. To calculate the average price adjustment, we have weighted those reported in the ICMA survey between investment grade and high yield relative market volumes, and also adjusted for the average term structure of the underlying market (noting that the survey data is based on a typical 5-year maturity bond). This suggests an average price adjustment of 103c. We present a similar analysis based on settlement data and the weighted average expected price adjustment for Government bonds.[17]

Annualizing this data, we can estimate an annual cost of €0.9bn being passed on to investors to cover dealers' additional buy-in risks. This of course, is just one bond market segment (NFCs), and relates only to transactions settled on one CSD (Euroclear). But it provides an illustration of the expected cost impact in response to the additional market risks introduced by mandatory buy-ins.

[16] It is important to note that the data does not differentiate between outright transactions and SFTs, and therefore not all settlement fails at ISD+7 would necessarily be in scope of CSDR buy-ins. However, it remains useful for illustrative purposes.

[17] The analysis also takes account of the fact that CSDR does not have a pass-on mechanism, meaning that every settlement fail results in a buy-in. An effective, flexible pass-on mechanism would reduce both the numbers of buy-ins and the economic risks to market-makers.

Table 1: Estimated cost to investors through dealer price adjustment (NFCs & Government bonds, Euroclear)

NFCs	Fails @ISD+7	Expected fails (trades)	Expected fails (vol)	Avg price adjustment (103c)
Total (Jan-Aug)	1.41%	49,892	€60,763,879,051	€625,867,954
Annualized total:	1.41%	74,838	€91,145,818,577	**€938,801,931**
Government bonds				Avg price adjustment (14c)
Total (Jan-Aug)	0.19%	12,181	€159,706,745,067	€223,589,443
Annualized total:	0.19%	18,272	€239,560,117,601	**€335,384,165**

The cost of the buy-in agent is not included in the above calculation. Historically, in the cross-border bond markets market-makers would provide buy-in services on a pro bono basis and, more recently, investment firms have been able to execute the buy-in themselves. Thus all of the buy-in cost related to the buy-in final price.

Since mandatory buy-ins requires the appointment of a buy-in agent this will come at an additional cost which also needs to be included in the calculation above. Using the same Euroclear Bank data set for both NFCs and Government bonds, and assuming a buy-in agent fee of (i) 25c and (ii) 50c, we get a sense of the aggregate impact of this element (see Table 2). Again, this is something that dealers will need to build into their price adjustments. This becomes a cost incurred indirectly by investors to pay for buy-in agent services.

Table 2: Estimated annual cost of buy-in agents (fails on Euroclear only)

	Expected fails (vol)	Buy-in agent costs (based on 25c)	Buy-in agent costs (based on 50c)
NFCs	€91,145,818,577	€227,864,546	€455,729,093
Government bonds	€239,560,117,601	€598,900,294	€1,197,800,588

While the above analyses help to illustrate the overall economic impacts of mandatory buy-ins for market participants (primarily investors), what they cannot quantify is the opportunity cost of fewer trades and reduced market liquidity, particularly for less liquid sub-classes such as corporate bonds and emerging markets. Nor is it easy to estimate the additional impact of the reduction of lending in these markets and how this will further affect pricing and liquidity in the underlying markets.

The analysis also focuses on the transfer of risk and costs between market-makers and investors in response to mandatory buy-ins. What it cannot show is how a reduction in liquidity in secondary markets impacts primary markets over the longer term, both in terms of pricing and access, which has very direct consequences for the wider economy.

This is why ICMA and its members advocate that before implementing the mandatory buy-in regime, the European Commission and ESMA undertake a detailed and thorough impact assessment. This will provide a clearer picture of the true cost of the regulation, direct and indirect, and what this will likely mean for the future development of the EU's bond markets.

Differentiated buy-ins (and equivalent remedies)

No size fits all

As previously pointed out, buy-ins are a well-established risk management tool, widely relied upon in the non-cleared bond markets, and imbedded into the contractual trading arrangements between trading parties.[18] It is important to recognize, however, that while buy-in mechanisms largely perform the same function and are based on very similar principles, different markets may rely on alternative contractual frameworks, which have been developed as most appropriate for the underlying market structure and dynamics. For example, the ICMA Buy-in Rules, which are widely relied upon in the cross-border bond markets (including credit, sovereign bonds, and emerging markets) are slightly different in a number of respects to FINRA Buy-in Rules, which are used in the US domestic bond market. Such differences are generally limited to characteristics such as scope and timings with respect to notification and necessitated by differences in market structure.

Adaption to evolving market structure and conditions

It is also important to appreciate that as underlying markets evolve, it may be necessary to revise the related buy-in frameworks to ensure that they remain relevant and optimized to the needs of market participants. For example, over the past ten years the ICMA Buy-in Rules have seen several updates. These include the removal of the requirement for a pre-advice notice (which was considered to have become redundant), more flexibility in terms of the buy-in notification period (to facilitate alignment with non-ICMA buy-ins) as well as removing the requirement to appoint a buy-in agent, subject to certain best execution and conflicts of interest parameters (this is discussed in more detail further on in the response). These revisions were made with relative agility and in direct response to the identified needs of the underlying market.

Buy-ins not always the appropriate remedy

It should also be noted that buy-ins are not always the appropriate remedy for certain markets or transaction types. Securities financing transactions (SFTs), for example, do not generally apply buy-ins as this type of remedy is not necessarily consistent with the structure and economics of a short-term loan of securities and, in most cases, these would not provide the non-failing party with a suitable outcome. Furthermore, SFTs support a range of different roles, which also needs to be considered when determining the appropriate remedy for a settlement fail. Contractual frameworks such as the GMRA and GMSLA therefore provide SFT specific remedies that have been developed to suit the underlying transactions, and which are designed to manage the specific risks arising from those transactions.

[18] In the case of the ICMA Buy-in Rules, this is usually through incorporation by reference into firms' terms of business.

Flexibility is key

ICMA would therefore strongly advocate that buy-in frameworks (and similar remedies to manage the risks arising from settlement fails) be designed with the underlying markets in mind, ideally by the relevant market participants who rely on those remedies and to whom they apply. Imposing a regulatory, prescriptive, one-size-fits-all buy-in framework across a range of different securities, markets, and transaction types is inherently sub-optimal, potentially undermining the very purpose and benefits of buy-ins or similar remedies.

As already highlighted, such contractual frameworks already exist, particularly in bond and SFT markets. However, ICMA recognizes that in some markets they may not, which leaves a gap in terms of settlement risk management. This could possibly be filled by a regulatory requirement for EU investment firms to have such contractual arrangements in place (subject to adhering to some generic, high-level principles).

ICMA would further argue that this flexibility should also apply in the case of cleared bond and repo transactions, where CCPs are best placed to determine the design and calibration of the appropriate risk mitigation tools based on their specific structures and business models. This would also allow for CCPs to harmonize any buy-in framework with those used in the relevant non-cleared markets (e.g. allowing for pass-ons), which would further reduce overall settlement risk.

Pass-on mechanism

Pass-on mechanisms are a well-established and broadly understood risk mitigation tool used in the non-cleared securities markets in the case of multiple fails in the same security. For example, they are widely relied upon under the ICMA Buy-in Rules, and have proved to be a highly effective component of the contractual arrangements between trading parties. CSDR removes this important risk mitigant.

Context

The settlement of onward outright sales in non-cleared markets is often contingent on the settlement of an outright purchase of the same securities. In active markets this can create entire chains of transactions with dependent inward and onward settlements. Accordingly, a single settlement fail (at the start of the chain) can cause a sequence of settlement fails throughout the entire chain.

Buy-ins create additional risk, since they involve a new market transaction. Furthermore, they can be market distortive, since, as already explained, they are usually executed at an off-market price. In the case of transaction chains where a single failing settlement is the cause of multiple market fails, executing multiple buy-ins at the same time could result in excessive market volatility in the underlying (as well as related) securities, compromising market efficiency and stability. From a market efficiency and stability perspective, it is therefore undesirable to have multiple buy-ins being attempted in the same security within a relatively short timeframe. This is clearly visible from the analysis provided in the response to Question 35.1.

Mechanics of existing contractual pass-ons

In terms of the flow of trading party responsibilities through the transaction chain, the incentive (or obligation) to initiate the buy-in process is passed from the purchasing party at the start of the chain to the final purchasing party. The buy-in notice (and subsequent buy-in confirmation, detailing the buy-in status and execution) is passed from the final receiving trading party (the purchaser) in the chain to the original failing delivering trading party (the seller) at the start.

The main advantage of the buy-in being executed at the end of a transaction chain is that (if successfully executed) it ensures that the final receiving trading party in the transaction chain receives their securities. If the buy-in is executed earlier in the chain, other onward deliveries or further fails along the chain could mean that the buy-in only settles only part of the chain and the final receiving trading party is still left with a failing receipt. In the case of transaction chains with multiple intended settlement dates this also allows more time for the chain to settle naturally, before a buy-in is necessitated. Furthermore, it prevents contingent parties in the chain from making decisions, such as electing to extend the buy-in or going to cash compensation, that will be beyond the control, and best interest, of the final receiving (purchasing) party.

Once the buy-in is executed, the initiating party (the final purchaser in the chain), via the buy-in confirmation, will pass the buy-in details on to their failing seller, who in turn will pass this on to their failing seller, and so on along the chain, with respect to each individual transaction, until the details reach the original seller. As the details are passed between parties, so they will cancel their original settlement instructions and instead settle between them the differential between the buy-in price (including any associated costs) and the original agreed trade price. Any final costs associated with the buy-in (primarily the buy-in premia - i.e. the difference between the buy-in price, or the cash compensation reference price, and the current market price for non-guaranteed delivery) are ultimately borne by the original delivering trading party (the failing seller). Everybody else in the chain, including the final receiving trading party, is restored economically to the position they would have been in had the original trade(s) settled.

Importantly, **there does not need to be a holistic view of the entire settlement chain**, and trading parties do not need to know where they are in the chain: trading parties merely need to know that they have a failing inward receipt and a dependent onward delivery to be able to pass-on any buy-in notice. Furthermore, **pass-ons are not CSD-specific**, and can be used efficiently to settle transaction chains that involve multiple CSDs, and, in theory, across different jurisdictions.

Why CSDR is incompatible with pass-ons

The importance of a pass-on mechanism seems to be recognized in both Recital 19 of the Regulation ("*CSDs should be allowed to monitor the execution of a buy-in with respect to multiple settlement instructions on the same financial instruments and with the same date of expiry of the extension period with the aim of minimising the number of buy-ins*") and also in Recital 34 of the RTS, which provides that "*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*".[19] However, there is no pass-on mechanism outlined in the RTS themselves.

ICMA, as part of a cross-industry initiative, submitted a proposal and related Q&A to ESMA for a pass-on mechanism that could potentially work under the current regulatory framework. This included a proposal for transaction chains that share the same ISD, and (more representative of the real world) one for chains which with multiple ISDs. However, it is clear that a pass-on mechanism does not fit easily into the current regulatory framework.

There are two main reasons for why the current regulatory provisions are incompatible with a pass-on mechanism. Firstly, the fact that buy-ins are mandatory, not discretionary, affords little flexibility in terms of timing for a pass-on mechanism to work effectively (noting that in bond markets it is very common for transaction chains to consist of linked transactions with different intended settlement dates).[20] Secondly, the fact that CSDR buy-ins have an asymmetric requirement with respect to the price differential payment (see further on in this response) means that a pass-on mechanism would only be effective in the case where the buy-in price is higher than the prices of the original transactions through the transaction chain. In case where the buy-in price is lower, trading parties in the chain (who bought and sold securities in good faith, and are effectively flat) would be economically disadvantaged as a result of another party's settlement fail. From a risk management perspective, this would incentivize parties in a failing transaction chain to initiate a buy-in at the earliest possible opportunity,[21] rather than waiting for a pass-on.

ICMA would strongly argue that the optimal solution would be for pass-on, as with buy-ins in general, to be provided for under market-based contractual arrangements that reflect the underlying market structures and dynamics, rather than attempting to (re)introduce them through prescriptive regulation.

Buy-in agents

The objective of a buy-in is to ensure that the non-failing purchaser of securities is able to force delivery of those securities (generally at their discretion), ensuring that the economics of the original transaction are maintained and that they are not disadvantaged economically. For a buy-in to be successful the process must therefore provide additional market liquidity beyond that already available to the failing seller. Theoretically, using a buy-in agent to facilitate a buy-in provides access to additional liquidity, as well as ensuring impartial best execution (i.e. no conflict of interests which could be to the disadvantage of the failing party). In reality, appointing a buy-in agent is no guarantee of either increased liquidity or best execution, and therefore it is important that the non-failing party initiating the buy-in has as much flexibility and agency in managing the process as they require.

[19] However, it is important to recognize that CSDs are not in a position to identify transaction chains not to oversee pass-ons: this can only be done effectively at the trading party level. Furthermore, pass-ons, like transaction chains, are CSD agnostic.
[20] More flexible buy-in timelines could be supportive of a pass-on mechanism.
[21] Contractual buy-ins can still be utilized before the end of the extension period. In many cases there will be an incentive for parties to initiate a buy-in immediately, rather than wait until the CSDR buy-in is triggered.

The historical role of buy-in agents in the bond markets

Historically, buy-ins under the ICMA Buy-in Rules required the initiating party to appoint a buy-in agent. Traditionally, the buy-in agent would be any market-maker for the security being bought-in.[22] Market-makers were considered best placed to act as buy-in agents due to their distribution networks, and the fact that they would know to which clients they had sold the underlying security previously and who may therefore be open to selling them into a buy-in. Furthermore, they were likely to have an existing relationship and credit line with any potential seller, as well as with the initiating party. Since holders of the relevant security may be required to replace anything they sold into the buy-in, market-makers were also in a good position to offer them a substitute investment (usually for a relative 'pick-up' in yield or spread). Finally, market-makers usually have a familiarity with the market for the relevant security, and are best able to determine what is a fair market price, as well as an appreciation of the liquidity, depth, and volatility of the security.

Buy-in agents would therefore act as specialist principal brokers, sourcing the securities via their franchise, at the best possible price in light of market liquidity and current conditions, and selling the securities on to the initiating party. In short, they brought liquidity to the process.

While the ICMA Buy-in Rules allowed the buy-in agent to be remunerated for the buy-in execution (to the extent that this was 'reasonable and consistent with the level of risk, skill, costs, or effort undertaken'), in most cases the buy-in agent would put the trade through 'for flat' (i.e. no additional cost). This was partly because buy-ins are considered to be a service to the broader market, but also because market-makers did not want to be seen profiting from a transaction that would leave another counterparty (usually a fellow market-maker) deep out-of-pocket.

While the appointment of a buy-in agent was previously a requirement of the ICMA Buy-in Rules, by 2016-17 it became clear that finding a buy-in agent was increasingly challenging. Informal consultation with members highlighted a number of reasons why market-makers were reluctant to continue acting as buy-in agents in the international bond markets:

(i) *Time and effort.* Bond markets were becoming increasingly illiquid, making it harder to source securities. Accommodative monetary policy, and the 'hunt for yield' by investors also meant that holders of securities were becoming ever more reluctant to sell them, even with the enticement of a buy-in premium. Even if buy-in agents could charge for a fee for executing the buy-in, many felt that it was still too much time and effort for relatively little reward.

(ii) *Reputational risk.* As buy-ins became harder to execute, particularly for less liquid securities, so the potential for buy-in premia to become exaggerated also increased. In these cases, there was the potential for the party being bought-in to dispute the buy-in price, which could potentially bring the initiating party and the buy-in agent into conflict. Many firms indicated that they did not wish to assume this risk, no matter how small it might be.

In 2017, following a formal consultation of ICMA members, users of the ICMA Buy-in Rules (which include both buy-sides and sell-sides) voted overwhelmingly to remove the requirement to appoint a

[22] The ICMA Buy-in Rules required that the buy-in agent was not affiliated with the initiating party, nor that they sourced the securities, directly or indirectly, from the initiating party.

buy-in agent. Since then, firms initiating a buy-in may source the securities themselves, within certain parameters intended to protect the integrity of the buy-in process. These include: (i) not being able to use their own stock, or that of an affiliate, to settle the buy in, and (ii) *"acting in good faith, in the best available market for guaranteed delivery…",* taking *"into account such factors as price, cost and size of the trade and the liquidity of the market."*

Stakeholder feedback since this change has been positive, indicating that it has greatly improved the efficiency of the buy-in process. Furthermore, any concerns about inflated buy-in premia as a result of the absence of a neutral third-party seem to have been unjustified.

The CSDR requirement to appoint a buy-in agent

Since CSDR requires the appointment of a buy-in agent, it is imperative that a healthy range of buy-in agents exists in the bond market. Ideally these are market-makers, who not only have the expertise and experience of the relevant market and securities, but who are able to leverage their franchise to source the securities, and potentially offer other securities (switches) to would-be sellers. This is also important to ensure that firms initiating buy-ins, as well as potential sellers into a buy-in, have enough relationships and credit lines with buy-in agents. The role of the buy-in agent is essentially to increase liquidity in a situation where liquidity is overtly lacking. If buy-in agents cannot do this, then buy-ins will remain challenging, if not impossible, to execute. If market-makers, or other product specialists such as inter-dealer brokers (IDBs), cannot be enticed to act as buy-in agents, then it is difficult to see where this liquidity will come from, particularly if there are limited alternative options. This highlights an imbedded weakness in the current regulation.

CSDR creates potential challenges for market-makers or brokers who otherwise may be willing to undertake the role of buy-in agent. Firstly, there is the potential for conflicts of interest (noting that Article 24 of the RTS states that *"any buy-in agent shall not have any conflict of interest in the execution of a buy-in and shall execute the buy-in on the terms most favourable to the failing…trading party"*). It is not entirely clear what this could mean, particularly in the case of market-makers or brokers who may have positions, axes, or client orders in the underlying security as a natural consequence of their business. Similarly, the potential for conflicts of interest could spill over into the post-trade space, where such firms may also have prime brokerage or custodian businesses with settlement obligations in the securities being bought-in. In the absence of a clear definition of conflicts of interest in the role of the buy-in agent, market-makers and brokers are likely to take a conservative view.

Secondly, given the various additional reporting obligations under the mandatory buy-in framework, and the potential for a significant increase in the number of buy-ins being initiated, any firm acting as a buy-in agent will likely need to invest heavily in both infrastructure builds and dedicated staff (both trading/broking and operations) to support this service. Acting as a buy-in agent is therefore a long-term commercial decision that needs to be weighed against the potential returns from dedicating resources to other, more profitable client services. If the outcome of CSDR buy-ins is to change trading behaviour (creating fewer fails through a long-only market), rather than generating multiple buy-ins, then the commercial appeal of becoming a buy-in agent goes away.

Thirdly, given the uncertainty related to the eventual design of the buy-in regime, or even whether buy-ins will remain part of the Settlement Discipline package, it would seem unlikely that any firm would look to put itself forward as a buy-in agent before knowing what the regulation will eventually require, and so possessing a fuller understanding of both the investment commitment and the commercial viability.

In the absence of an adequate buy-in agent ecosystem post-CSDR, it is likely that many, if not most, buy-ins in illiquid bonds will be unsuccessful, resulting is mandatory cash settlement ('cash compensation'), which creates as much risk and inconvenience for the original purchasing party as it does for the failing seller, therefore undermining one of the assumed aims of the SD regime (i.e. investor protection). Furthermore, it is not clear how the provisions for determining cash compensation, as outlined in the RTS, are expected to be applied in the case of bond markets (see further on in this response).

Appointing buy-in agents should be discretionary

The requirement to appoint a buy-in agent under the CSDR buy-in framework is potentially extremely problematic, particularly from the perspective of bond markets. Traditionally, buy-in agents were market-makers for the relevant securities, who were able to apply their product knowledge and experience and leverage their client franchise in order to fulfil the buy-in. In recent years, market-makers have withdrawn from providing buy-in services, largely due to the challenges, and risks, associated with acting in this capacity. Under CSDR these risks are likely to be even greater. While there is still time for more solutions to put themselves forward, the fear is that they do not, and that by the time the mandatory buy-in provisions come into force, most buy-ins will not be successfully executed, resulting in a mandatory cash settlement mechanism that may also prove to be problematic, if not unimplementable. If buy-ins are to remain part of the CSDR-SD regime, it would seem to be important that not only is there the possibility to appoint a far broader range of actors as buy-in agents (in particular established liquidity providers), but the requirement to appoint a buy-in agent be removed altogether, and that, subject to best execution requirements and clearly defined limitations on conflicts of interest, firms are able to execute their own buy-ins. The worst possible scenario is that firms wishing to initiate buy-ins (whether mandatory or discretionary) face a limited option of buy-in agents, recognizing that this may not only be due to the fact that they simply do not exist, but also due to a lack of contractual arrangements, credit lines, or operational interoperability.

However, the optimal solution remains that firms be able to execute buy-ins at their own discretion under market-based contractual arrangements, rather than being mandated by prescriptive legislation that does not necessarily reflect underlying market structures and dynamics, and which risks undermining the very purpose of a buy-in. This would not diminish the role of buy-in agents or other third-party initiatives that facilitate the buy-in process: on the contrary it would be consistent with a competitive market and investment firms' requirements to obtain best execution.

More can be found in an ICMA 2020 Briefing Note on CSDR mandatory buy-ins and the requirement to appoint a buy-in agent.

Scope

Currently there are a number of ambiguities around the intended scope of application of the CSDR buy-in provisions, some of which are the subject of outstanding industry requests for 'Level 3' guidance through the ESMA Q&A process. These include the application to SFTs,[23] collateral movements, portfolio transfers, the physical settlement of derivatives, securitized derivatives and structured products where such products have a physically-deliverable feature, the ETF creation process, primary issuances the ETF creation process, and other transaction types where a buy-in would make no sense from an economic or risk mitigation perspective. Much of the cause of this ambiguity seems to stem from the fact that CSDR Article 7 does not distinguish between a market trade (i.e. the outright purchase and sale of a security) and a settlement, noting that the latter could apply to a whole range of transaction types or processes.

This again highlights the advantage of market-based contractual buy-in frameworks over an attempt to apply a regulatory, prescriptive, one-size-fits-all buy-in regime across a whole range of different markets, securities, and transaction types.

Only appropriate for certain transaction types

If buy-ins are to remain in CSDR, then it will be essential to ensure that the scope of application is not only unambiguous, but that at the very least the scope is narrowed to markets and transaction types where a buy-in, in principle, makes sense from an economic or risk mitigation perspective.[24] However, thought also needs to be given to how a CSDR buy-in would interact with existing buy-in frameworks (such as ICMA and FINRA), particularly with respect to extraterritorial application, whether this could create uncertainty for market participants as to which buy-in process should take precedence, and what would be the implications of this from the perspective of an EU investment firm's ability to manage its risk appropriately.

Trading level

Again, if buy-ins are to remain in CSDR, the 'Level 1' Regulation should be revised to reflect the fact that in the case of non-cleared trades, buy-ins should only take place at the trading level (i.e. between the trading entities party to the failing trade), and that CSD participants, trading venues, and any entities other than the relevant trading parties, should not be involved in the buy-in process.

Symmetrical differential payments

The economic function of a buy-in

The starting point for understanding the economic function of a *buy-in* (and, similarly, cash settlement) is recognition of the legally binding nature of a financial transaction. When parties enter into a financial transaction, for the purchase and sale of financial securities (e.g. equities or bonds) the buyer will be entitled to the full economic benefits (and liabilities) of ownership of the security, including any change in value of the security. This remains true whether the securities are physically settled or not. Non-settlement does not provide either party (purchaser or seller) with the unilateral right to cancel the trade, nor to change the economics of the trade (i.e. the principle of 'benefit of bargain' is maintained).

[23] See ICMA's FAQ on CSDR mandatory buy-ins and Securities Financing Transactions
[24] It is important to note that the scope for buy-ins is likely to be much narrower than that for cash penalties. These mechanisms are very different in terms of purpose and outcomes, which needs to be considered when determining their suitability and application.

Buy-ins are a contractual remedy that can be applied, by the disappointed purchaser, in the case of non-settlement of securities by the seller. A buy-in is intended to enforce settlement of the securities (by obtaining them from a third-party seller for guaranteed delivery). The buy-in process ensures that the purchaser is restored to the economic position they would have been had the original transaction settled. Buy-ins are not intended to change the economics of the trade. Neither party has the right to benefit from 'windfall' profits or incur unexpected losses at the expense, or to the benefit, of the other party.[25]

The economic function of cash settlement ('cash compensation')

Cash settlement (erroneously/inappropriately referred to as 'cash compensation' in CSDR) is a back-stop resolution in the case that a buy-in cannot successfully be executed. As with a buy-in, the intention is to restore the parties to the economic position they would have been in had the original transaction settled. While the disappointed buyer will not receive their securities (the original transaction is essentially *cashed out*), they will be entitled to the full economic benefits (and liabilities) of ownership of the security, including any change in value of the security. As with a buy-in, cash settlement is not intended to change the economics of the trade. Neither party has the right to benefit from windfall profits or incur unexpected losses at the expense, or to the benefit, of the other party.

In the case of cash settlement, the settlement payment is based on the economic benefits that the purchasing party would have received had the original transaction settled (including any accrued interest, dividends or coupons, etc.) as well as <u>any change in market value</u> (i.e. the difference between the original transaction price and an agreed market reference price).

Cash penalties

Cash penalties penalize failing sellers and compensate failed-to purchasers. Cash penalties therefore *are intended* to change the economics of a trade[26] in the event of a fail (advantaging the purchaser and disadvantaging the seller). But, most importantly, the costs/benefits are largely predictable and entirely consistent.

In the case of intermediaries (with a matching purchase and sale), they are neither economically advantaged nor disadvantaged (they may have an economic incentive to borrow securities, but not to initiate an independent buy-in).

Consequences of asymmetrical payments for buy-ins / cash settlement

Currently, the CSDR RTS suggest an asymmetrical treatment for settling the price differential between sellers and purchasers in the cases of both a buy-in and cash compensation/settlement. That is:

(i) where the buy-in price or cash compensation/settlement reference price is higher than the original transaction price (i.e. the market has moved higher since the purchaser bought the securities), this differential is paid from the seller to the buyer (restoring the original economics of the trade).

[25] In essence, cash penalties replicate the economic impacts of a fail in a 'normal' interest rate environment and eliminate any adverse incentives to fail that arise in low or negative interest rate scenarios.
[26] In essence, cash penalties replicate the economic impacts of a fail in a 'normal' interest rate environment and eliminate any adverse incentives to fail that arise in low or negative interest rate scenarios.

(ii) Where the buy-in price or cash compensation/settlement reference price is lower than the original transaction price (i.e. the market has moved lower since the purchaser bought the securities), this difference is 'deemed paid'. This is not in accordance with existing market practice and contractual formation where the economics of the original trade are maintained. Ordinarily, in this scenario the differential (with respect to the market movement) is paid by the buyer to the seller.

This asymmetry is the economic equivalent of the seller of the securities also writing an at-the-money put option, which is then owned by the purchaser, and which becomes active in the event of a buy-in or cash compensation. In other words, every purchaser of a security is given a free option to benefit from a market drop below the original transaction price to the detriment of the seller. It is worth highlighting that any options, whether a call (i.e. the option to buy a security at a mutually agreed trigger price at a set date) or a put (i.e. the option to sell a security at a mutually agreed trigger price at a set date), are instruments that are negotiated and traded at a price in financial markets. The Regulation creates what are in effect *free* options, which will benefit some market participants, at a cost to others, as a result of certain market movements that are beyond the control of those participants. The cost of such options is likely to be reflected either in a wider bid-offer spread, or reduced liquidity provision for less liquid instruments, ultimately disadvantaging the very same failed-to party CSDR is intending to protect. The result will be a distortion of otherwise rational economic decisions and the disruption of efficient and orderly markets.

As well as creating an additional risk for all sellers of securities (who are effectively short this put option), the effect of this anomaly in the Regulation is also to create additional risks for intermediaries (counterparties who have matched purchases and sales), since they are effectively now short a *put-spread*. In the case of symmetrical payments, intermediaries are protected by *pass-on* mechanisms.[27] However, as explained in the section under 'Pass-ons', a pass-on cannot work in the case of asymmetrical payments. If the buy-in (or cash compensation/settlement) reference price is lower than the intermediary's original trade price, both transactions are effectively cancelled under CSDR, and any differences 'deemed paid'. In other words, the P&L generated by their sale and purchase will be lost, even where they are not the cause of the fail.

Hence the asymmetry inadvertently impacts not only the original failing party, but every party in a transaction chain, with the exception of the final purchaser (who has the possibility of a windfall profit). Thus pass-ons become impossible in many circumstances. Furthermore, it increases the incentive for all parties in a transaction chain to initiate a contractual buy-in[28] as quickly as possible (i.e. immediately) as everybody scrambles at the same time to ensure delivery in order to protect their P&L from the regulatory asymmetry.[29]

[27] This allows matched buyers and sellers to pass-on a buy-in, without incurring any additional costs.
[28] Contractual buy-ins (such as the ICMA Buy-in Rules) generally do not have an 'extension' period and can be initiated at any time after the intended settlement date.
[29] In line with the effective 'option' risk of parties in the transaction chain, the higher the probability of the option being 'in-the money' (i.e. the closer the market price is to the original transaction prices), the greater the incentive to initiate an immediate, independent, contractual (non-CSDR) buy-in.

Figure 5: CSDR settlement discipline – cash penalties and buy-ins/cash compensation

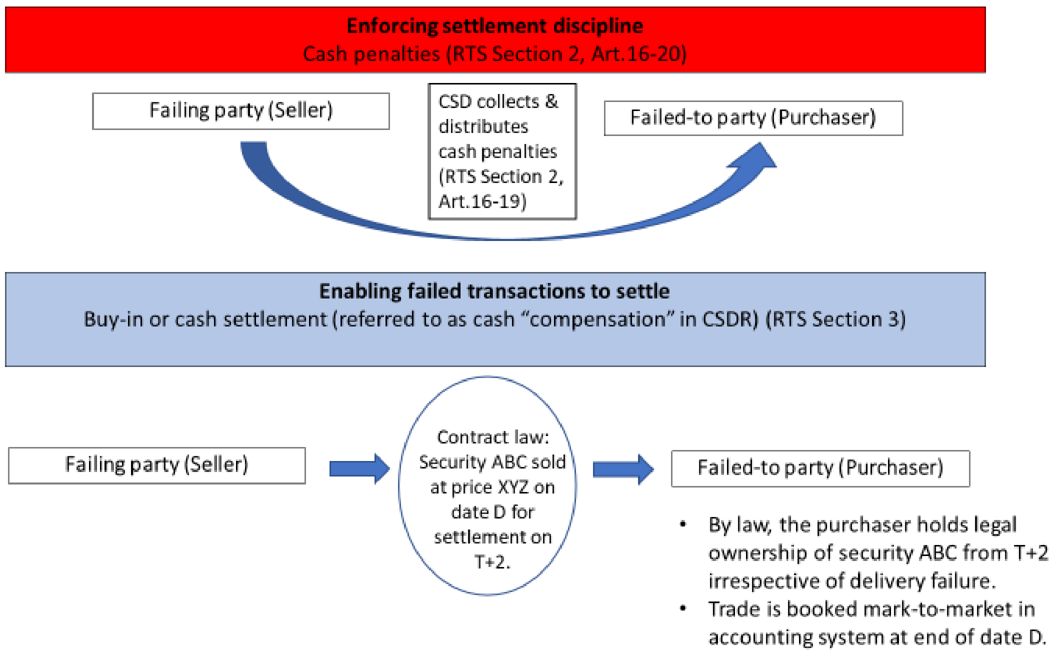
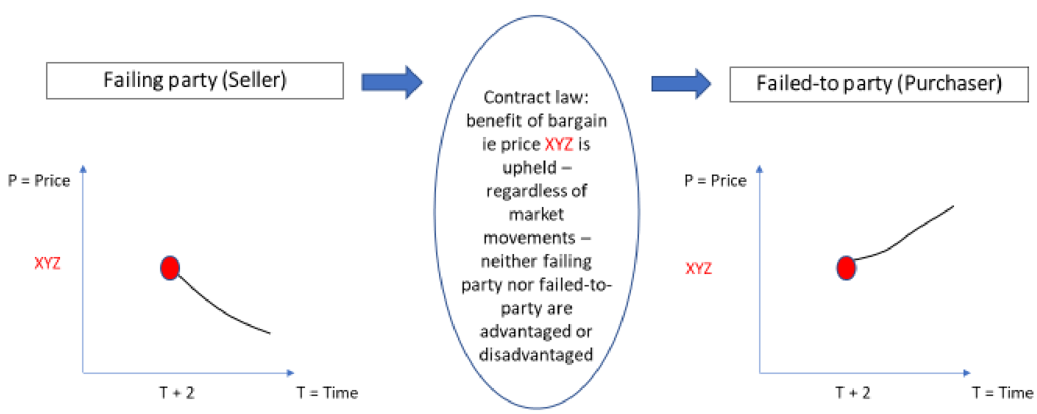


Figure 6: the economic function of buy-ins / cash settlement



- The buy-in process enables the purchaser to source the security from a third party. If P > XYZ on the date of buy-in execution, the failing party makes a payment (P-XYZ) to the failed-to party. In case P < XYZ , the failed-to party makes a payment (XYZ-P) to the failing party. In both cases, price XYZ is upheld as per contractual agreement.
- In case the security cannot be sourced eg there is no buy-in agent or seller for the specific security, the failing party and failed-to party agree to settle cash. Price XYZ is upheld and payments are made either from the failing party to the failed-to-party or vice versa, depending on the mark-to-market value of the security (even though there is no physical delivery).
- ***Note:*** The failing party continues to incur cash penalties which are passed on by the CSD to the failed-to party as long as the transaction has not settled.

Figure 7: CSDR settlement discipline – payments between parties

One-way payment from failing party (seller) to non-failing party (buyer)

Payment possible in either direction depending on market value vs contract price

Penalty for failure **Paid by the failing party (seller) to compensate the non-failing party (buyer)**	Reflecting the economic exposure **Paid in either direction, to restore original economics of the trade**	Other trade components **Paid by the failing party (seller) to the non-failing party (buyer)**
Irrespective of whether settlement failure results in a buy-in or cash settlement, the CSD collects & distributes cash penalties **from the seller to the buyer**.	Irrespective of whether settlement failure results in a buy-in or cash settlement, the resulting account/settlement **should reflect the fact that the buyer has an economic exposure to the market value of the securities from the intended settlement date**. If the market value is higher than the contract price, the differential should be paid from the seller to the buyer. If the market value is lower than the contract price, the differential should be paid from the buyer to the seller.	Irrespective of whether settlement failure results in a buy-in or cash settlement, the resulting account/settlement reflects the **buyer's right to accrued interest or coupon payments**.

Other important considerations for the design of CSDR buy-ins

There are a number of other important considerations with respect to the design of the CSDR buy-in framework which will need to be addressed if buy-ins are to remain a feature of CSDR-SD.

Cash compensation

As explained in the section on 'Symmetrical differential payments', cash settlement (referred to as 'cash compensation' in CSDR') is an important alternative resolution to the buy-in process in cases where the buy-in does not result in the securities successfully being sourced. Mandating cash settlement, in the same way as mandating a buy-in (as explained earlier in this response) creates additional risks, and potential costs, not only for liquidity providers, but also for investors. These impacts are further compounded by the fact the methodology outlined in the RTS for determining cash settlement is inadequate from the perspective of bond markets.

Risks to the non-failing party

Cash settlement in most cases, is not optimal from the perspective of the non-failing purchaser, whose desired outcome will vary depending on the market, product, and circumstances (and which is why it is not ordinarily a mandated resolution). In the case of a buy-in, the buyer is indifferent to the price at which the buy-in is executed, since they will receive their securities while also being made economically whole through the buy-in differential payment, which will include any associated costs of the buy-in (such as agent fees or brokerage).[30]

However, in the case of cash compensation, and conversely to the situation of the seller, the main risk facing the buyer is in the case that the cash compensation reference price is set at a level lower than their tolerance range for what constitutes fair market value (and again where they are likely to have the position marked on their books).

This consideration is further complicated in the case of the seller in that any losses may not purely be linked to the cash compensation market value. It is likely that they will also have contingent positions and exposures that will require unwinding in the event of cash compensation (which could include interest rate swaps, exchange traded futures, CDS, short bond positions, foreign exchange, or any combination of these or other securities).[31] At the very least the buyer is likely to incur the bid-ask spread associated with unwinding any contingent exposures, as well as any potential slippage.

A further consideration is that alternatively the buyer may have a mandated requirement to hold the exposure, out of which the cash compensating mechanism inadvertently will be forcing them. In this case they may be forced to replace that exposure immediately, either by purchasing the same or similar bonds, and potentially at a premium to market fair value (themselves becoming a 'distressed buyer').

[30] Again, we will assume that the buy-in differential payment asymmetry in the regulation is remedied by contractual arrangements between the trading parties and which ensure that the economics of the original transaction are restored.
[31] Bonds are relative value instruments and are not typically traded or managed on an outright basis.

Risks to the liquidity providers

The principal risk for market-makers and other liquidity providers arising from cash settlement is related to the determination of the cash compensation reference price. If this is significantly above what is considered to be fair market value, this will be a direct cost (in the form of a mark-to-market loss) for the failing seller. While buy-ins are likely to create costs for the selling party in the form of any buy-in premium (see explanation earlier in this response), this can at least be attributed to an actual transaction. In the case of an off-market cash settlement reference price, this is harder to justify. In many respects, this outcome is an even more daunting risk for liquidity providers than a physical buy-in. A similar consideration applies to lenders of securities.

Determining the cash compensation reference price

Clearly it is important that in the case of a mandatory cash settlement regime that both liquidity providers and investors can rely on fair and consistent reference prices. This becomes challenging in the case of illiquid securities that do not trade on a regular basis. And in the case of securities that cannot successfully be sourced through a buy-in, it is reasonable to assume that these are amongst the least liquid securities.

Article 32(3) of the RTS outlines three methodologies to be used to determine the market value for calculating cash compensation. The first methodology (a) uses the closing price of the most relevant market. This appears to be primarily equity focused (as per MiFIR), and since bonds do not really trade on a particular market. The third option (c) is for the parties to agree on a pre-determined methodology (subject to approval by NCAs). This seems to reflect the methodologies generally employed by CCPs (again, more equity focused), and is potentially intended to apply to instruments that are neither equities or debt.

The second methodology (b) uses the closing price of the trading venue with the highest turnover in the relevant security. This is interpreted as applying to bond markets (as per MiFIR), but raises a number of challenges in the case of less liquid market segments, such as credit and emerging markets.[32]

Firstly, it may be difficult to establish what is the trading venue with the highest turnover. Bonds are traded across multiple venues, as well as off-venue, which could include with SIs (Systematic Internalisers) and non-SIs. From this perspective, it is far from clear how to determine the appropriate venue, or on what basis.[33]

Secondly, even if one could establish the appropriate venue, in all probability there is not likely to be a closing price, given that the underlying security is almost certainly highly illiquid. Any price that is quoted on a venue is therefore likely to be a quote, rather than a print from an actual transaction (otherwise one can only assume that the buy-in agent would have been able to buy the securities). As such, it is either likely to be un-executable (i.e. indicative), or relates to a speculative bid or offer that could be far from fair market value. In either case it is an unreliable point of reference for establishing the cash compensation market value.

[32] Closing prices are more readily available in the case of more liquid sovereign bond markets, across a range of venues. However, fails, particularly aged fails, in these securities tends to be rare, and the probability of a buy-in going to cash compensation is extremely low.
[33] This is potentially a situation where a Consolidated Tape for bonds could be of some help.

In all probability, given that the underlying security is almost certainly going to be highly illiquid, and confirmed by the fact that a buy-in could not successfully be executed, there is unlikely to be any reliable price on any venue which could be used as a credible reference price for the purposes of cash compensation. Given the infrequency with which illiquid bonds trade, there may also be few historical prints that can be referenced. In fact, it may be that the last recorded transaction in the security is the one between the parties that they are now trying to cash settle.

Thus, from a practical perspective, methodology (b) would seem extremely limited in its applicability with respect to bond markets.

Revising the provisions for cash compensation

In light of the challenges inherent in determining a reliable reference price as the basis for cash settlement, particularly with respect to less liquid securities, and the significant risks that this creates for both liquidity providers and investors, ICMA and its members strongly recommend that if a buy-in regime is to remain in CSDR-SD, along with the buy-in process becoming discretionary, any cash settlement resolution should be negotiable between the parties, rather than enforced and determined by a prescriptive methodology that will not work in reality. An indefinite timeline to complete the buy-in (or at least a significantly longer timeline than the current seven business days plus one deferral) would further help in reducing any further risks to trading parties, providing more time for the buy-in to result in physical delivery of the securities.

More on the identified deficiencies in the CSDR provisions for cash compensation in the case of bond markets can be found in an ICMA 2020 Briefing Note.

Guaranteed delivery

Contractual buy-ins (such as the ICMA Buy-in Rules) are often for guaranteed delivery. This provides the non-failing party with recourse to the party selling into the buy-in, in the event that the buy-in settlement fails. This is important for two reasons:

(i) It helps to ensure that any firm selling into the buy-in not only owns the securities, but is confident that they are able to make delivery (e.g. the securities have not been loaned-out or settlement is not contingent on the settlement of another transaction).[34]

(ii) It limits the market risk faced by the failing seller, since their obligation to deliver will cease at the moment of execution of the buy-in and not when the buy-in settles. This is important as they will be able to hedge or unwind the new position created by the buy-in immediately following the buy-in (i.e. they have certainty of their market exposure). If the buy-in were not guaranteed and its success contingent on successful settlement, the non-failing party would not know with certainty what their market exposure was in the period between the buy-in execution and the eventual outcome of the settlement. For buy-ins with regular settlement, this could be more than 48 hours. During this time, the failing party will not know for sure whether they have been bought-in, and therefore unable to manage their risk.

[34] If the only outcome of the settlement of the buy-in failing is that it is canceled, this provides a 'free option' for speculative short-selling into the buy-in in an attempt to capture any buy-in premium.

An alternative to guaranteed delivery would be instantaneous (or at least T+0) settlement for the buy-in, which would achieve the same objectives. However, instantaneous, or even T+0, settlement may not be possible for many holders of securities and therefore could exclude them from being able to offer securities into the buy-in. Where a longer settlement period is required to facilitate the buy-in, guaranteed delivery should be a requirement in order to de-risk the process.

Procyclicality

ICMA and its members do not have reason to believe that cash penalties necessarily add to procyclical risk. This is primarily because they do not change in response to market conditions. Under stressed market conditions, where settlement fails could increase, market-makers will likely reflect the additional risks of penalties in their bid-ask spreads. But these additional costs are predictable and constant, and should not in themselves impact liquidity provision.

This is very different to mandatory buy-ins, which are inherently procyclical, as illustrated in the response to Question 35.1. Under stressed market conditions, mandatory buy-ins will naturally amplify the negative liquidity feed-back loop, potentially destabilizing markets.

Penalty rates

ICMA and its members have no strong views on the current calibration of the penalty rates for fixed income. ICMA would recommend that the cash penalty mechanism be implemented as soon as practicable, taking on board any logistical recommendations from the CSD and CCP communities, and that the regulatory authorities monitor its impact on both settlement efficiency rates and market liquidity over an appropriate time period that would also allow time for the infrastructures and their members to address any implementation challenges. Once the regime has been allowed sufficient time to run, any possible recalibration of both the penalty fees and scope of application should be based on an analysis of any impacts, and in light of the explicit (and quantifiable) objectives of the SD regime. During this time, mandatory buy-in should not be implemented, for all the reasons already outlined.

Question 35: Would the application of the settlement discipline regime during the market turmoil provoked by COVID-19 in March and April 2020 have had a significant impact on the market?

-Yes

-No

- Don't know / no opinion

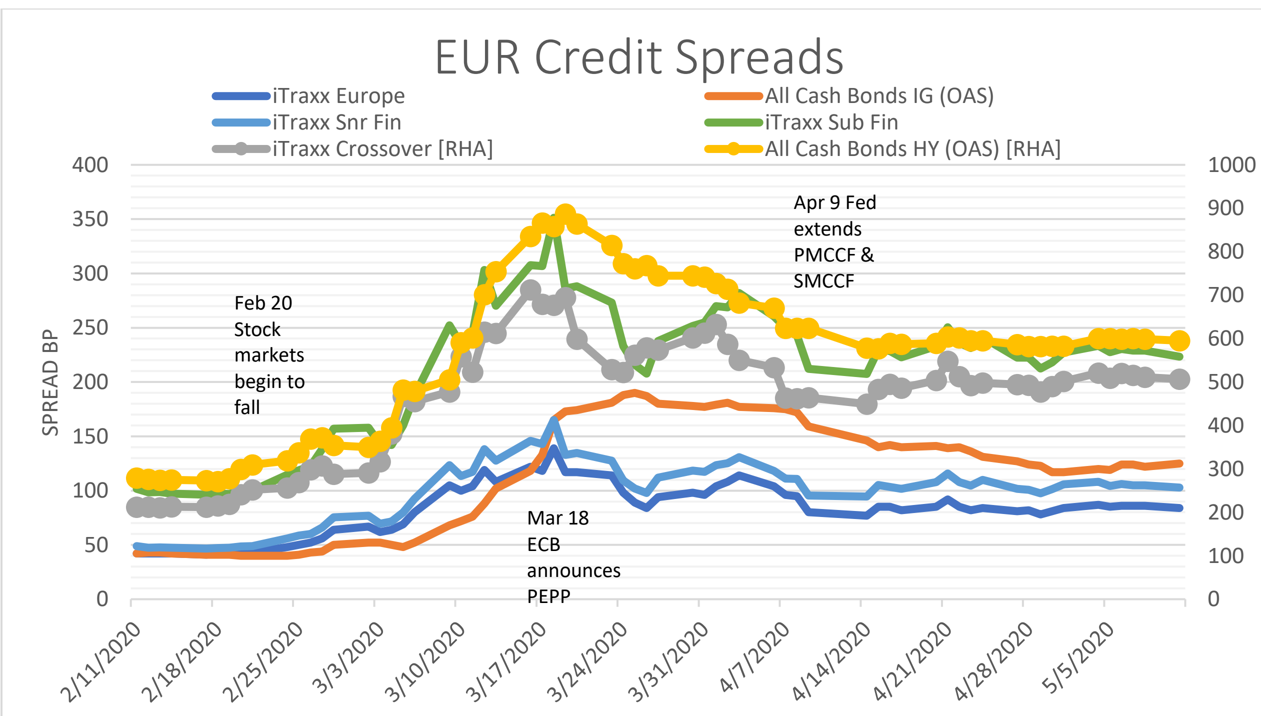
Question 35.1 Please explain your answer to Question 35, describing all the potential impacts (e.g. liquidity, financial stability, etc.) and providing quantitative evidence and/ or examples where possible:

COVID-19 and the bond markets

The extreme stresses on bond market functioning and liquidity at the peak of the COVID-19 related turmoil in March and April of 2020 are well documented (e.g. the ESRB's *Issues note on liquidity in the corporate bond and commercial paper markets*, the BIS's *Corporate credit markets after the initial pandemic shock* ,the FSB's *Holistic Review of the March Market Turmoil*, AFME's *Impact of COVID-19 on European Capital Markets*, and ICMA's *The European investment grade corporate bond secondary market & the COVID-19 crisis*). All of these seek to describe how volatility spiked significantly, market liquidity became severely impaired, and, in some instances, bond markets became dysfunctional.

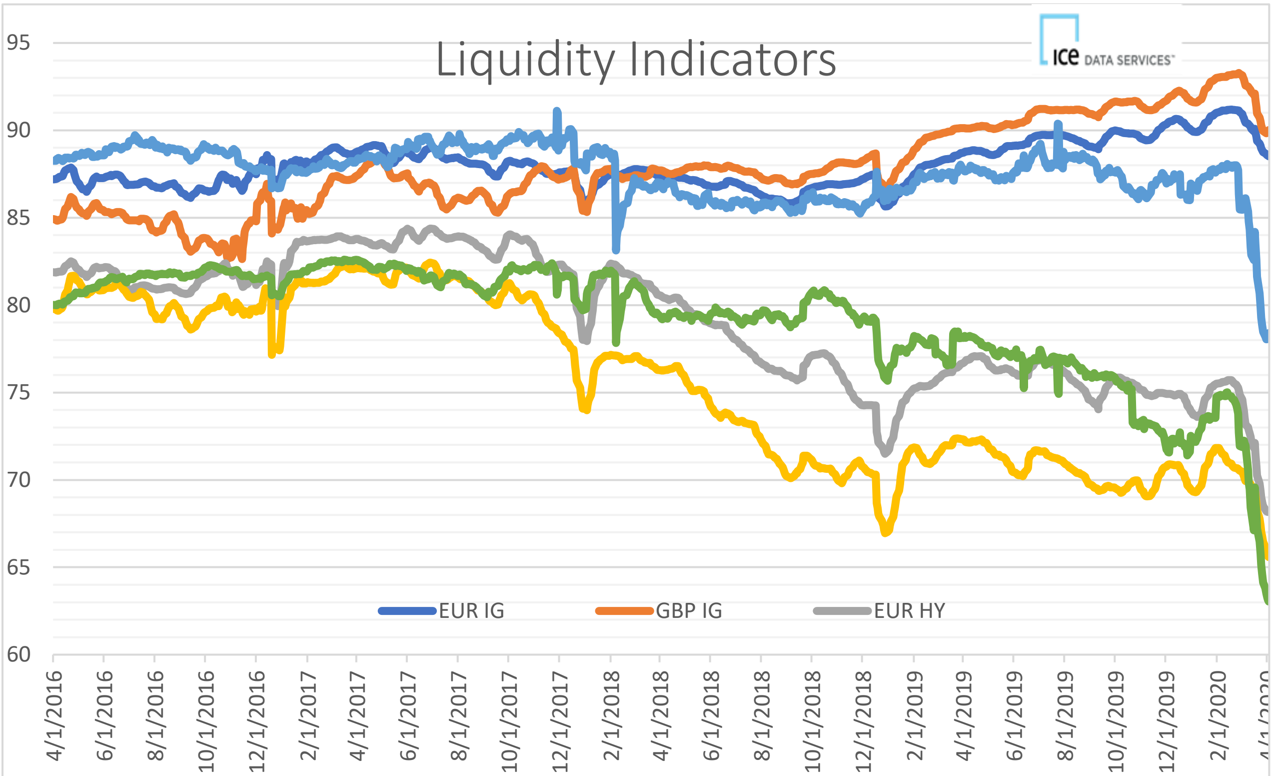
Figures 8 and 9, taken from the ICMA report, respectively illustrate the impact on both euro credit spreads and corporate bond market liquidity.

Figure 8: EUR corporate credit spreads and the COVID-19 crisis



Source: ICMA analysis using Bloomberg data

Figure 9: ICE Data Services Liquidity Indicators ™



Source: ICE Data Services

ICE Data Services' Liquidity Indicators are designed to reflect the average liquidity across the three major currencies by tracking the changes in weighted-average liquidity costs over time for both portfolios of Investment Grade and High-Yield securities. The cost calculation used in these indicators is based on an estimate of market price impact. This price impact metric incorporates security-level features, including projected trading volume capacity, transaction costs, price volatility, etc. to estimate the liquidity cost measured as a percentage of the bid price.

Settlement fails during the COVID-19 market turbulence

The ICMA report also reflects on the reported increase in settlement fails that occurred at the end of March and beginning of April. It is noted by a number of buy-side and sell-side participants that there was a sizeable, albeit temporary, increase in settlement fails during the height of the crisis. This is largely attributed to operational challenges related to transitioning middle- and back-office teams to disaster off-sites and home-working, as well the impact of lockdowns on outsourced settlement teams (such as those based in India), at a time when overall trading volumes were significantly above average. As some explained, it was important, at least for a short-while, to tolerate settlement fails in order for the market to continue to function.

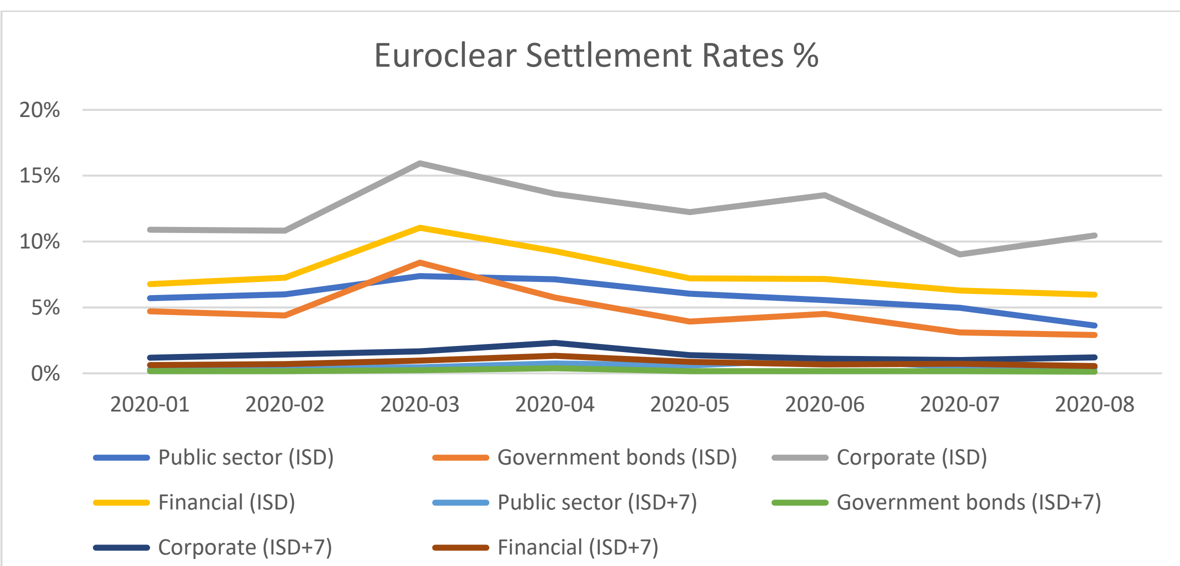
Nonetheless, it is evident that the market did take steps to contain settlement risk during this period, including (I)CSDs notably opening on the weekend in order to process the growing backlog of settlement instructions. Both buy-sides and sell-sides also report issuing contractual buy-in notices in selective instances to help expedite the settlement of 'sticky fails' (while acknowledging that successfully executing an actual buy-in would have been challenging, and the settlement-chain ramifications too difficult to contemplate). By early April it would appear that settlement efficiency rates normalized.

This increase in structural settlement fails has accentuated concerns about the EU's CSDR mandatory buy-in provisions, due to come into force in early 2021, and raises questions as to how this would have impacted the market if it had been in place during the Covid-19 turbulence. The general view of participants is that it would have turned a crisis into a catastrophe. Firstly, the time and resources required to manage the buy-in process (which requires operational, trading, and legal input) would have been a significant drain on already stretched staff. Secondly, trying to buy-in illiquid securities in an already stressed and often chaotic market would only have exacerbated market volatility, while compromising market stability. And thirdly, anything that further restricts market-maker capacity would have been an additional blow to liquidity at a time when it was most needed.

Analysis

In an attempt to quantify how the CSDR mandatory buy-in regime would have impacted Europe's bond markets during this period (and more generally), ICMA obtained settlement efficiency data from Euroclear Bank. Figure 10 shows the monthly rate of failed instructions for bond transactions on both intended settlement date (ISD) and ISD+7 (when the buy-in requirement would be triggered). It can be seen that settlement fails increase notably in March and April 2020, in particular for corporate bonds.

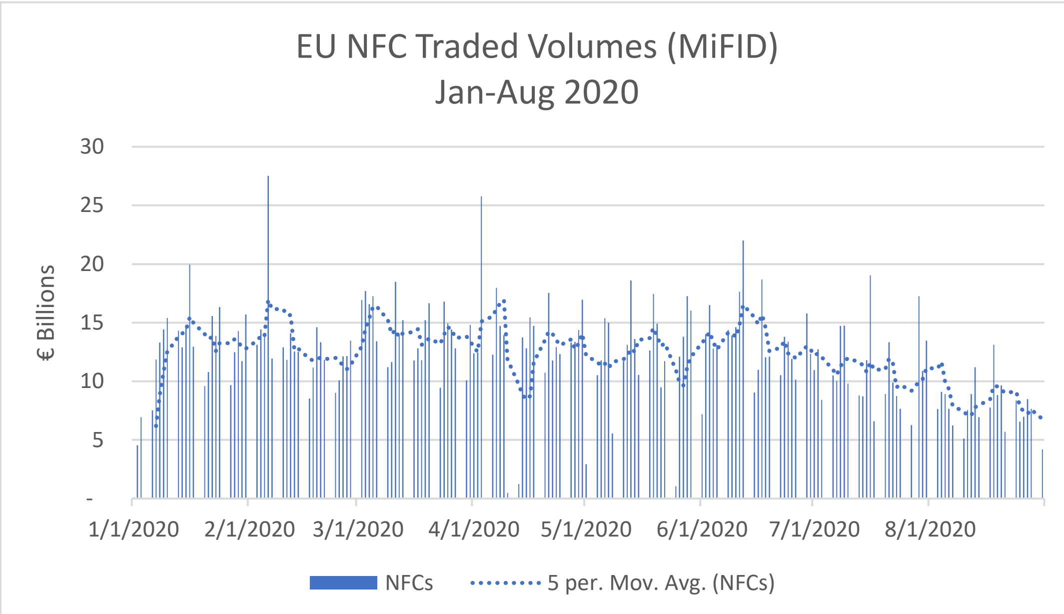
Figure 10: Euroclear settlement fails for bonds (Jan-Aug 2020)



Source: ICMA analysis using Euroclear Bank data

Figure 11 shows MiFID transaction data for daily volumes in non-financial corporates (NFCs) for the period January through August 2020.

Figure 11: MiFID volumes for secondary market transactions in non-financial corporates (Jan-Aug 2020)



Source: ICMA analysis using Bloomberg data

To estimate the impact of the CSDR buy-in regime during the period January through August 2020, ICMA has overlaid the monthly traded volumes for non-financial corporate bonds with the Euroclear fails rates for ISD+7 (this assumes that the Euroclear Bank data is typical across other EU CSDs). This is illustrated in Figure 12.

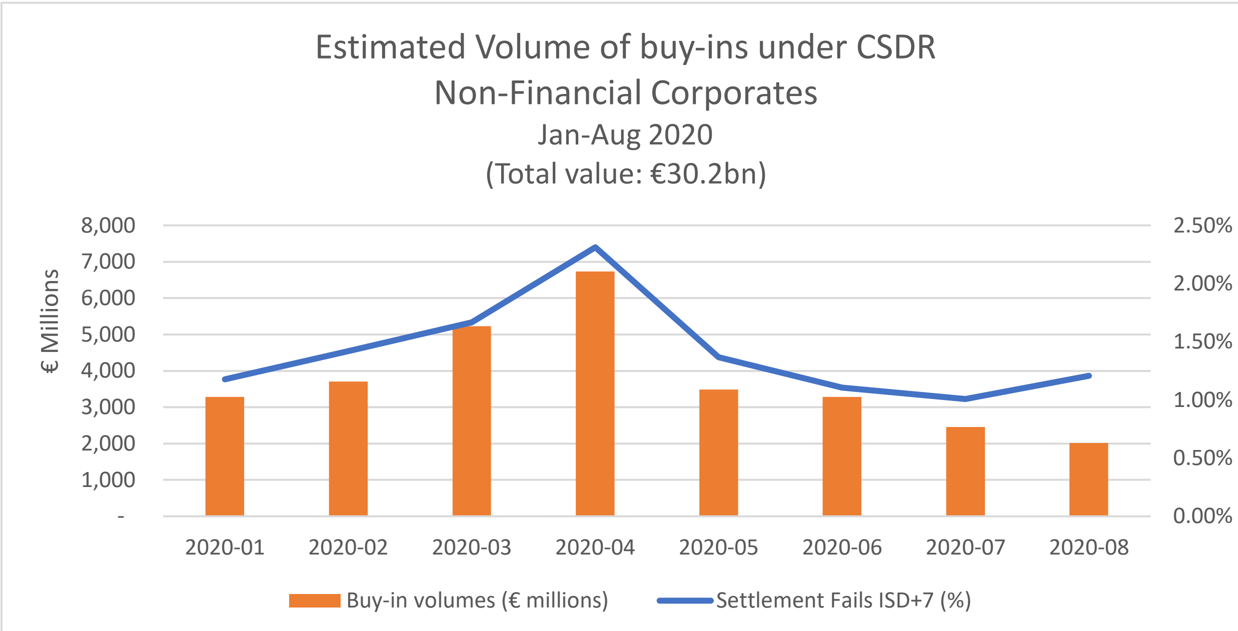
When viewing the analysis, it is important to remember that not every transaction results in a settlement instruction, as there will be a level of transaction netting, both through CCPs (mainly for sovereign bonds) as well as internal netting. Accordingly, the estimates for total buy-in volumes are likely to be larger than they would be in reality (while also bearing in mind that a reduction in liquidity as a consequence of the CSDR buy-in regime would most likely reduce overall trading volumes).

A further consideration is that the settlement data does not differentiate between outright cash transactions and SFTs (noting that most SFTs should have been be out of scope).[35] However, in the case of settlement efficiency rates, this is unlikely to have a material impact.

This analysis suggests that even in normal market conditions, the monthly volumes of buy-ins for non-financial corporate bonds alone would be significant (more than €3bn per month). At the peak of the March-April market turmoil, however, this would have reached almost €7bn.

[35] Although the exact scope for SFTs is yet to be clarified.

Figure 12: Estimated volume of buy-ins of NFCs that would have been triggered by CSDR



Source: ICMA analysis using Euroclear and Bloomberg data

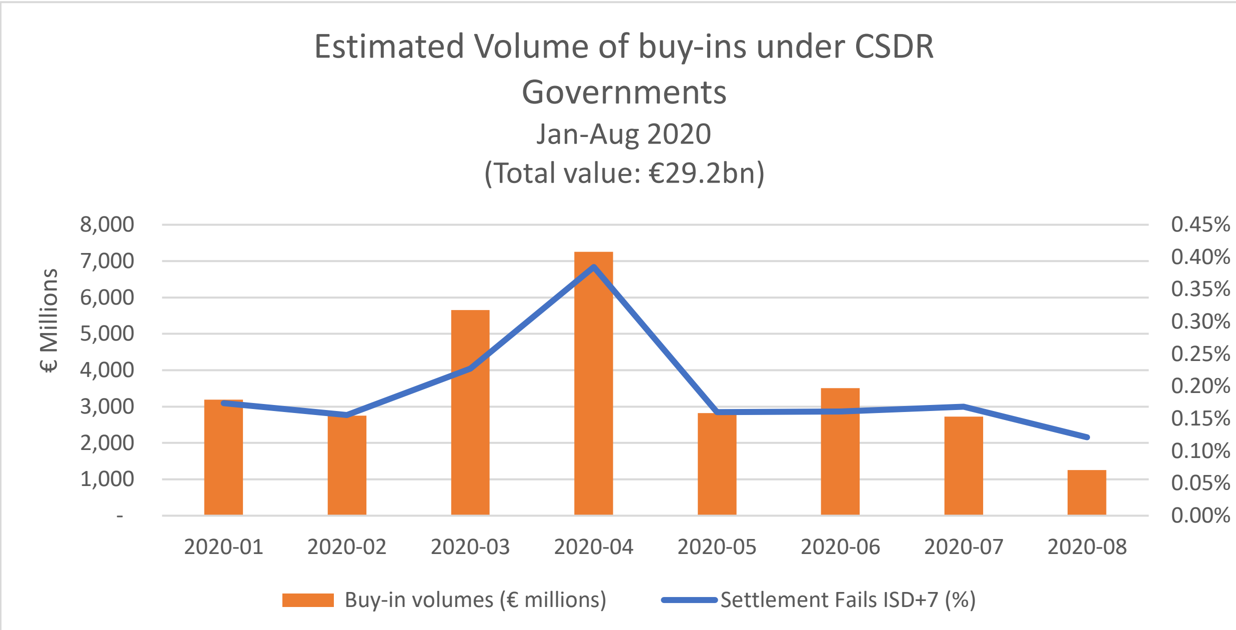
A similar impact would have been observed across all sectors of the EU bond market, including for sovereign bonds (see Figure 13), which have the highest settlement efficiency rates of any asset class.[36]

Using a similar analysis (overlaying MiFID traded volumes with Euroclear fails rates for ISD+7), we can expect to see typical monthly volumes of buy-ins of around €3bn, but this would have increased to more than €7bn at the peak of the turmoil.

These types of volumes for buy-ins would almost certainly be disruptive in times of normal market liquidity. The sharp rise in required buy-ins at a time when markets were already at their most stressed and least liquid could have been catastrophic for Europe's bond markets with grave systemic consequences for the entire financial system.

[36] The fact that transaction netting is not accounted for probably overstates the impact

Figure 13: Estimated volume of buy-ins of government bonds that would have been triggered by CSDR

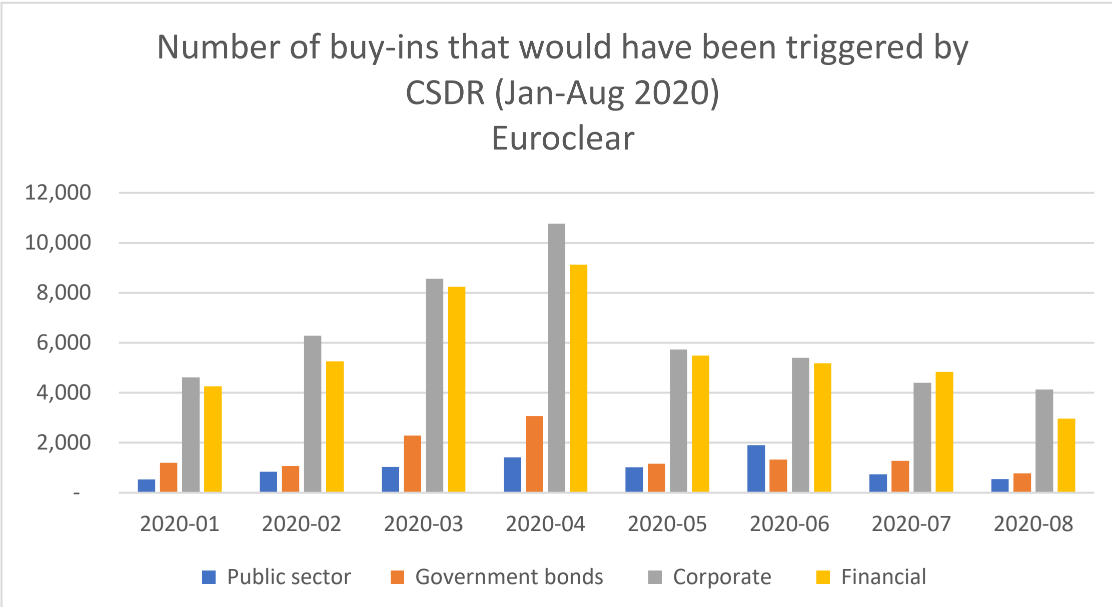


Source: ICMA analysis using Euroclear and Bloomberg data

While the impact of the volumes of bonds being bought in as a result of CSDR is clearly significant, the number of individual buy-ins that would have been triggered also provides interesting analysis (noting that CSDR has no pass-on mechanism, so every individual fail at ISD+7 would result in its own buy-in). Again using Euroclear Bank data (and therefore only relating to failed settlement instructions),[37] the number of required buy-ins in the European bond markets in a typical month would be significant (around 13,000). At the peak of the turmoil this would have increased to well over 20,000 (see Figure 14). Combining this impact for all EU (I)CSDs would of course increase this number significantly.

[37] These numbers may be slightly overstated due to the inclusion of SFTs, many of which would have been exempted from the buy-in requirement

Figure 14: Estimated number of buy-ins triggered by CSDR (Euroclear only)



Source: ICMA analysis using Euroclear Bank data

For ICMA and its members, the quantitative evidence of the impacts of the CSDR mandatory buy-in regime for European bond market functioning, liquidity, and stability is both stark and alarming. Even if the impact is overstated due to the inclusion of certain SFTs and the omission of settlement netting, this is unlikely to be by substantive, and we can confidently expect the numbers to remain significant.

Market stakeholders can only be grateful that the regime had not been implemented prior to March 2020, and hopeful that the lessons learned from this analysis prompt a more thorough regulatory impact assessment before attempting implementation of the current framework, whether in February 2022 or anytime thereafter.

Question 36. Which suggestions do you have for the improvement of the settlement discipline framework in CSDR? Where possible, for each suggestion indicate which costs and benefits you and other market participants would incur.

What ICMA presents in its response to this consultation is essentially a 'waterfall' of proposals for implementing the Settlement Discipline regime, based on members' assessment of what is most optimal in terms of minimizing disruption to the orderly functioning of Europe's bonds markets, while still attaining the objective of improved settlement efficiency. The suggested, alternative options can be summarized as:

1) implement cash penalties, only; or
2) implement cash penalties and also mandate that investment firms have in place contractual frameworks to remedy fails; or
3) implement the CSDR buy-ins regime as a last resort, but with a number of critical revisions to the current framework the most important of which being that **the initiation of the buy-in should be at the discretion of the non-failing party** (see the response to Question 34.1).

ICMA and its members would reiterate that it would be in the best interests of the EU bond markets that a regulatory buy-in regime is not implemented as currently provided for in the regulation, and that instead ESMA proceeds with implementing the cash penalty mechanism, monitoring its impacts, and recalibrating as necessary. Meanwhile, both public and private stakeholders should continue to address many of the issues related to the complex and fragmented structure of the EU settlements landscape, which is the primary cause of settlement inefficiencies in EU bond markets.

While effective and appropriately designed buy-in frameworks and equivalent remedies already exist in a number of markets (such as for bonds and SFTs), they do not exist for all markets. A more proportionate and less disruptive approach could be the introduction of a regulatory requirement that all investment firms have in place such contractual provisions with their counterparties. This would require the introduction of new contractual provisions in some markets, but many markets (such as bonds and SFTs) would likely satisfy relevant regulatory requirements.

The least optimal option would be to proceed with the existing regulatory buy-in framework, but with a number of targeted revisions designed to address many of the implementation challenges and to mitigate some of the additional risks and undesirable market impacts. These revisions are presented and explained in the response to Q34.1.

In considering the costs and benefits of these suggestions, the contractual implications are paramount. The contractual work required by Article 25 of the RTS, is extensive and global, requiring the remediation or replacing of existing agreements covering all potentially in-scope markets, instruments, and transactions. In the case of markets with existing contractual settlement failure remedies, the imposition of a regulatory buy-in regime offers no additional risk mitigation and may in fact be regarded as a risk amplifier.

The prescriptive and idiosyncratic provisions of the CSDR buy-in process also require significant investment and resource allocation to design and build the necessary workflows and architecture to support implementation. Given the current implementation timeline and the likelihood for any subsequent revisions to the buy-in provisions, much of this significant contractual and operational work may need to be repeated. It is also not clear what benefits this would provide beyond those achieved by allowing (or mandating) investment firms to rely on market-based contractual frameworks (whether existing or new).

An outline of the associated costs and benefits of each of these options for market participants is provided in Table 3 blow:

Table 3: costs and benefits of alternative suggestions to improve CSDR-SD

Suggestion	Benefits	Costs
Implement cash penalties but not regulatory buy-ins	There is evidence to suggest that appropriately calibrated cash penalties can improve settlement efficiency, particularly in cases of high settlement fails. The investment and resources required to support the implementation of the CSDR buy-in regime is vast and could be better allocated by investment firms, particularly in supporting the post-COVID economic recovery. Investors and issuers in EU bond markets would not be subject to likely negative impacts of detrimental pricing, reduced liquidity, and potential market instability resulting from the CSDR buy-in regime. Investment and work by infrastructures and investment firms to support implementation of the penalty regime has largely already been committed or undertaken. In preparing for the SD regime, investment firms and market infrastructures have already undertaken extensive work to develop processes and	Investment and resource allocation required to support the implementation of cash penalties.

	architecture to improve settlement efficiency.	
All EU investment firms required to have in place contractual buy-in provisions or equivalent	*All of the above, plus:* Markets or products where buy-in mechanisms (or the equivalent) do not exist would be required to introduce them, enhancing the overall structure for settlement efficiency. In many cases these provisions already exist, significantly reducing the overall industry cost and effort of implementation.	Investment firms would be required to develop and implement contractual arrangements with their counterparties for products and markets where these do not already exist.
Proceed with regulatory buy-in regime, with appropriate revisions	Markets or products where buy-in mechanisms (or the equivalent) do not exist would be required to introduce them (through Article 25 of the RTS), enhancing the overall structure for settlement efficiency. *However, in many cases this will be suboptimal since it will be duplicating what already exists, only with an inferior/less appropriate alternative.*	The investment and resources required to support the implementation of the CSDR buy-in regime is vast, both in terms of the extensive contractual papering (and re-papering) and the necessary architecture build. There is also the risk that much of this implementation work could be redundant or may need to be repeated. Depending on whether the buy-in requirement is mandatory, or any revision of the extension periods, investors and issuers in EU bond markets could be subject to the likely negative impacts of detrimental pricing, reduced liquidity, and potential market instability (the extent of which having been highlighted earlier in this response).