ICMA

CSDR Settlement Discipline

CSDR Mandatory Buy-ins & the requirement for a buy-in agent
An ICMA briefing note
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Overview

Since it entered into law in 2014, ICMA has questioned the need for, and design of, the EU CSDR mandatory buy-in regime, highlighting cross-industry concerns that not only is it likely to be damaging to bond market liquidity, efficiency, and stability, but many requirements of the Regulation potentially render the initiative unimplementable. ICMA maintains its position that other measures to improve settlement efficiency, such as cash penalties, should be implemented, and possibly recalibrated as appropriate, while the need for and design of the buy-in mechanism be reviewed in the light of a rigorous market impact assessment as well as with reference to existing, market-based buy-in arrangements.

One particular industry concern relates to the Level 2 requirement to appoint a buy-in agent at the start of the mandatory buy-in process. This assumes a market infrastructure to support the regulatory buy-ins that does not exist. It is widely recognized that it may not be possible for purchasing parties to appoint a buy-in agent, either because there is no buy-in agent available for the relevant instrument or market, or because the purchasing party does not have a business relationship with any potential buy-in agents. If a buy-in agent cannot be appointed, it is not clear how the buy-in can successfully be executed, since the RTS require the appointment of a buy-in agent. Assuming this would make the buy-in unsuccessful, the mandated process would result in cash settlement ('cash compensation'), the provisions for which, in the case of illiquid bonds, may not result in an equitable outcome or, again, may not even be possible.[1]

This briefing note looks at the traditional role of buy-in agents in the European non-cleared bond markets, the reasons why buy-in agents are no longer required in the case of the ICMA Buy-in Rules, and the risks and implications arising from a lack of availability of buy-in agents for the purposes of the CSDR regime. It concludes that as part of the broader review of the CSDR mandatory buy-in framework, the requirement to appoint a buy-in agent be removed.

Regulatory context

The EU CSDR Settlement Discipline regime,[2] due to come into force in February 2021, but now expected to be postponed until February 2022, imposes a mandatory requirement for parties to execute buy-ins in the case of failing settlements on EU (I)CSDs. The Regulatory Technical Standards (RTS) include a provision that in the case of failing transactions not cleared by a CCP, where a buy-in is required (and

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[1] See ICMA briefing note outlining the identified deficiencies in the CSDR provisions for cash compensation in the case of bond market (May 2020)

[2] REGULATION (EU) No 909/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL (see Article 7)

possible) the initiating party shall appoint a buy-in agent.[3] At the time of publication of this paper, ICMA and its CSDR-SD Working Group members are only aware of one entity that has put itself forward to act as a buy-in agent under the CSDR framework, raising industry concerns as to whether the CSDR buy-in requirements can in fact be implemented.

The role of buy-in agents in the non-cleared bond markets

Historically, buy-ins under the ICMA Buy-in Rules[4] 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.[5] 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 are 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.

While the 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.

The requirement to appoint a buy-in agent

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:

[3] COMMISSION DELEGATED REGULATION (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline (see Articles 24, 29(1), and 30(1)).

[4] The ICMA Buy-in Rules are part of the ICMA Secondary Market Rules & Recommendations (SMR&Rs) that are used extensively by trading parties in the international non-cleared bond markets

[5] The 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.

(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.

(iii) *Lack of knowledge and experience*. Many younger, less experienced traders were not familiar with the ICMA Buy-in Rules or the process. Buy-ins are relatively rare, even in the less liquid segments of the bond markets, and many traders who may only have been in their roles for a limited number of years simply had not experienced a buy-in, either from the perspective of being bought-in or acting as buy-in agent.

In 2017, following a formal consultation of ICMA members, users of the ICMA Buy-in Rules voted overwhelmingly to remove the requirement to appoint a buy-in agent. Since then, firms initiating a buy-in may source the securities themselves, within certain parameters intended to protect the party being bought-in. 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.

CSDR and buy-in agents

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 would be 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.

However, CSDR creates further 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 part 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 MBI 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 MBIs 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.

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. 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.[6]

Conclusion

The requirement to appoint a buy-in agent under the CSDR MBI 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 (for example, the one solution that currently exists is essentially an auction platform rather than a market-maker), 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 mandatory buy-ins are to remain part of the CSDR-SD package, following the long-needed review, 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.

[6] See: CSDR Settlement Discipline Cash compensation in the case of bond markets - An ICMA Briefing note, May 2020

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 overly-prescriptive and potentially unimplementable legislation that fails to reflect underlying market structures and dynamics.

Annex: The risks arising from the buy-in process

Buy-ins are not a post-trade process. A buy-in is a market transaction, which creates both market risk and counterparty risk for the parties involved. This also plays a role in the decision to execute a buy-in, the choice of buy-in agent, and the willingness of firms to act as buy-in agents.

The bought-in party

The party being bought-in faces market risk. On execution of the buy-in their position will change. If they originally sold the position out of inventory, they will go from being flat to long the securities. If they originally sold the position short, they will go from being short to flat. In either scenario they will need either to re-sell the securities, or institute or unwind associated hedges. Thus, they are exposed to any market moves between the time of the buy-in execution and when they are able to execute their offsetting transactions. This highlights the importance of immediate communication in the buy-in process, particularly following successful execution: first between the buy-in agent and the initiating party, and second between the initiating party and the party being bought-in. In the case of pass-on situations, this process becomes more complicated since the communication will need to be passed along the chain. The longer it takes between the buy-in execution and the initial seller knowing that they have been bought-in, the greater the market risk they potentially face (noting that this risk is borne by the original seller, and not the other parties in the chain).

Another market risk faced by the party being bought-in relates to the buy-in premium: the difference between the current market price and the price paid in the buy-in, which is likely to result in a realized loss for the original seller. Buy-in prices are often at a premium to the current market fair value for a number of possible reasons. Firstly, and quite importantly, buy-ins are generally executed for *guaranteed delivery* (see further on), which creates additional risk for the seller into the buy-in, for which they may seek compensation in the form of a higher price. Secondly, in order to persuade holders of the security to sell into the buy-in this may require a bid that is more attractive than the current market levels, particularly if they are required to replace the securities with the purchase of a substitute position. Thirdly, buy-ins act as a signaling function to the market that there is a potential demand-supply imbalance in the market, as well as an 'impelled buyer', which will lead any potential sellers to adjust their offer prices higher. Finally, it should also be remembered that buy-ins tend to occur in illiquid securities, where offers may be thin, holders are reluctant to sell, and prices are highly sensitive to information.

The initiating party

The original purchaser to the trade should not incur any additional market risk,[7] since the buy-in does not change their position, it merely changes the selling counterparty. However, they will incur counterparty risk. From the execution of the original transaction until the execution of the buy-in, they will have counterparty risk with the original seller in the form of any changes in market value since entering into the original transaction. From the moment of the buy-in execution, this counterparty risk will switch to the buy-in agent until the buy-in settles (noting that guaranteed delivery should limit this exposure until the intended settlement date of the buy-in).

[7] Note that they will in the case of mandatory cash settlement (which is the case with CSDR)

Following the execution of the buy-in, there will be a residual counterparty risk with the original seller with respect to the difference between the value of the original transaction and the value of the buy-in, which is to be settled (as a cash payment) between the two parties,[8] and which could be in either direction, depending on whether the buy-in value is higher or lower than the original transaction value.[9] However, this price differential will also include the buy-in premium (the difference between the buy-in price and the market value at the time of the buy-in), which is ultimately a cost to the initial seller. In the case that the buy-in premium is considered unreasonable, the bought-in party may contest the buy-in price, potentially leading both parties into a legal dispute.

The buy-in agent

The buy-in agent also faces counterparty risk, firstly with the party that sells into the buy-in, and secondly with the initiating party. To some extent this is mitigated by executing the buy-in for *guaranteed delivery*. However, the buy-in agent also has reputational risk. Firstly, they may not be able to source the securities being bought-in. Secondly, the buy-in price could be disputed if it is considered to be too far above market (i.e. the buy-in premium is considered excessive in light of market liquidity and conditions).

The importance of guaranteed delivery

Guaranteed delivery is an important element of the buy-in process and is intended to provide a high degree of certainty that the securities purchased in a buy-in will settle on the intended settlement date. In the ICMA Rules, guaranteed delivery is a requirement of the buy-in, and is covered by Section 180 (Specials terms and conditions / Special situations). In most cases it will mean that the party selling into the buy-in (or their custodian) (i) holds the securities; (ii) that they have not been leant out; and (iii) that their ability to make good delivery is not contingent on the settlement of another transaction.

Guaranteed delivery is also important from the perspective of managing the market risk of the party being bought-in. Since the buy-in is executed for guaranteed delivery, this immediately removes the requirement for the original selling party to make delivery, and changes their position from that moment, providing them with certainty to enter into any offsetting transaction(s). The settlement risk now moves to the buy-in agent and, in turn, the party selling in to the buy-in. If this were not the case, and the settlement risk did not transfer at the moment of execution of the buy-in, this would create uncertainty for the party being bought-in, since they would not know for certain that their position had changed (with the requirement for any offsetting transactions) until the buy-in has settled. Given standard settlement (T+2), this could potentially mean the party being bought-in facing more than 48 hours of market risk. This would seem to be the case with CSDR buy-ins, where there is no requirement for guaranteed delivery.

Instantaneous settlement, or even same-day settlement, of the buy-in would help in reducing this risk, but in most cases this will be unlikely. Most sellers into a buy-in are likely to be investment funds or asset managers, who generally do not have the operational capacity for same-day settlement. Also, if they are selling the securities with a view to replacing them with another purchase (which will often be a

[8] This could also potentially include any direct costs incurred in executing the buy-in, such as fees or commissions
[9] Under CSDR, the payment can only go I none direction, creating additional market exposure for the seller in the case of the buy-in value being lower than the original transaction value (the economic equivalent of being short an at-the-money put option).

requirement under their mandates), they will almost certainly require standard settlement as a minimum.

An initiative of the ICMA CSDR-SD Working Group, a workstream of the ICMA Secondary Market Practices Committee.

Authored by Andy Hill, September 2020