International
Capital
Market
Association

European Commission publishes RTS for CSDR Mandatory Buy-ins

Briefing Note
ICMA Secondary Market Practices Committee (SMPC)
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Overview

On May 25 2018, the European Commission finally published the regulatory technical standards (RTS) for the mandatory buy-in regime as part of CSDR Settlement Discipline measures. This comes more than two years after the revised draft RTS were submitted by ESMA.

The finalized RTS are largely in line with the draft RTS put forward by ESMA in February 2016. Key aspects include:

(i) trading-level buy-ins (for the most part);
(ii) the requirement to appoint a buy-in agent;
(iii) 7-business days for fixed income before a failing trade mandates the start of the buy-in process;
(iv) 7-business days for fixed income allowed from the start of the buy-in to completion (i.e. settlement);
(v) cash compensation in the event that the buy-in is unsuccessful; and
(vi) an exemption for securities financing transactions with terms of less than 30-business days.

Other than the mandatory, non-discretionary requirement for firms to execute buy-ins, a number of implementation challenges resulting from the problematically drafted Level 1 remain, in particular: (i) an embedded asymmetry in the payment schedule in favour of the non-defaulting party (the so-called 'CSDR put');[1] (ii) the inability to pass-on buy-ins to CCPs; and (iii) the inability (in most instances) to pass-on buy-ins where the fail is caused by the failing end-leg of an SFT.

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[1] This asymmetry, which appears to be the result of a drafting error in the Level 1 regulation, creates bizarre economic outcomes and adverse behavioural incentives for market participants. Whereas buy-in mechanisms are generally designed to restore all parties to the economic position they would have been in had the trade(s) settled, CSDR mandatory buy-ins can actually alter the economic position for all parties, including for linked transactions in a settlement chain. For instance, the P&L of an entire transaction chain would be wiped out in the case of the buy-in price or cash compensation reference price being lower than the original transaction prices through the chain (which is often the case in a falling market), thus creating financial losses for counterparties who are not the cause of the fail. To protect themselves, intermediaries in a chain will be incentivized to initiate buy-ins against any failing counterparty immediately, rather than wait for a pass-on; hence single fails, in most instances, will trigger multiple and immediate buy-ins under the CSDR framework.

The European Parliament and Council now have three months to scrutinize the RTS before they are published in the Official Journal. The CSDR Settlement Discipline package, comprising both cash penalties and mandatory buy-ins, will then come into force 24 months following publication of the RTS in the Official Journal, and which is now expected to be **September 2020**

Expected cost and likely impacts of the regulation

ICMA has long argued that CSDR mandatory buy-in regime, as well as being fundamentally flawed in its design, will be severely damaging to European bond market liquidity and stability, particularly for less liquid markets such as those for corporate bonds and emerging markets.

Bond market liquidity

A market impact study undertaken by ICMA in 2015 illustrates the extent to which fixed income market-makers will adjust their offer prices to account for the additional risk that a mandatory buy-in regime introduces to the liquidity provision function. The analysis covers a range of different bond types, as well as accounting for underlying liquidity. The results show that even for the most liquid sovereign bonds, bid-ask spreads will need to double, while for less liquid corporate bonds, most dealers will simply withdraw offer-side liquidity, unless they are already positioned, creating a 'long only' market.

Based on 2014 European bond market volumes, and applying the average adjusted dealer offer-side pricing, the analysis estimates a cost of implementing the regime in excess of €30 billion per annum, that will effectively be borne by investors. This of course does not account for the cost in terms of reduced market liquidity and stability.

Repo and lending markets

A 2017 ICMA study into the state and evolution of the European credit repo market highlights the marked impact the mandatory buy-in regime will have on the SFT markets for corporate bonds. While SFTs are largely out of scope of the regime, participants in the study explain that the risks of lending bonds will increase exponentially under the regime, as in the event of a cash sale, a fail on the return leg of any SFT could lead to the seller (lender) being bought-in with limited scope to pass the costs on to the failing borrower. A number of asset managers and agency lenders explained that they would simply stop lending corporate bonds once mandatory buy-ins came into force. This in turn will increase risks and costs for market-makers, which will further undermine corporate bond market liquidity.

Buy-side risks

As well as introducing additional risks for bond market liquidity providers, the mandatory buy-in regime also creates additional risks for investors. Where a buy-in is not possible, the regulation dictates that the fail must be resolved with a cash compensation remedy. In the event of a settlement fail, purchasers of bonds may find that they are unwittingly forced out of their long positions in return for cash compensation (over which they have little or no control).[2] This uncertainty and effective increase in market exposure could be particularly costly for investors where the bond purchase is hedged or part of a package, including other bonds or derivatives, and which would subsequently need to be unwound as a result of the cash compensation.

Market stability

The RTS do not explicitly provide for a pass-on process, whereby a chain of fails can be settled efficiently with a single buy-in. Furthermore, the rigidity of the timing for mandatory buy-ins can also create multiple breaks in settlement chains where there are different trade and settlement date, while the risks arising from the asymmetric settlement of the buy-in or cash compensation differential makes a pass-on mechanism effectively defunct. Also, the RTS do not allow for a buy-in to be executed against a CCP. All of these inflexible features of the regulation significantly increase the probability of fails-chains prompting multiple buy-ins, where a single buy-in would ordinarily suffice. If this is not de-stabilizing enough, the lack of discretion with respect to the timing of the buy-in means that buys-in will often be initiated without any regard to optimal market timing or liquidity, with the potential to distort prices significantly. Multiple, poorly timed buy-ins being initiated in the same bonds will increase market volatility and undermine stability. Again, it will be the less liquid bond markets, such as corporates and emerging markets, that will be most adversely impacted.

Extraterritorial impacts

The regulation calls on all parties in a settlement chain to have contractual arrangements in place with their relevant counterparties which contain the buy-in process obligations and are enforceable in all relevant jurisdictions. This is likely to prove highly problematic with respect to counterparties located in non-EU jurisdictions where mandatory buy-ins do not exist, and particularly with respect to the asymmetric risks and unusual economic outcomes of the CSDR buy-in process. Non-EU counterparties will face significant and unpredictable risks when dealing with EU counterparties or settling in EU CSDs, and may be reluctant to sign any agreement that tries to impose the obligations of the CSDR buy-in process.

CMU

The CSDR mandatory buy-in framework is in complete contradiction to the explicit aims of the EU's Capital Market Union initiative. In November 2017**,** the European Commission's Expert Group on Corporate Bond Markets recommended that the implementation of the proposed CSDR mandatory buy-in regime be delayed in order to review its provisions before attempting implementation. The recommendation is one of 22 put forward by the industry group in its report, Improving European Corporate Bond Markets, intended to improve the efficiency and functioning of the European corporate

[2] The reference price for cash compensation is to be determined by: (i) the closing price on the most relevant market in terms of liquidity; (ii) the closing price on the venue with the highest turnover of the relevant security; or (iii) an approved, pre-agreed methodology between the parties.

bond markets, an objective of the CMU initiative. The potential risks to market stability stemming from the mandatory buy-in provisions are discussed further in the Expert Group's accompanying report, Analysis of European Corporate Bond Markets.

Next steps for ICMA

ICMA remains committed to raising awareness and understanding of the flaws and impacts of the CSDR mandatory buy-in regime, and engaging with market stakeholders, regulatory authorities, and policy makers to pursue constructive and effective measures to support bond market settlement efficiency, without compromising market liquidity and stability, or creating unnecessary additional risks and costs for both investors and liquidity providers. To this end ICMA, on behalf of its diverse membership, will continue to advocate for improvements in market settlement infrastructure, and to support an effective, appropriately calibrated cash penalty mechanism for bonds.[3]

Buy-in rules

The ICMA Buy-in Rules are the most widely used and recognized buy-in framework in the international cross-border fixed income markets and have been relied upon for more than 40 years to provide an efficient and effective means of managing settlement risk. In the coming months, ICMA will consult with its broad and diverse international membership to review and revise the ICMA buy-in rules, which it expects will continue to be the pre-eminent contractual mechanism and 'best practice' for buy-ins for the non-cleared international, cross-border bond markets. The revised rules will not only need to be compliant with the regulatory requirements of CSDR but should also attempt to solve for some of its more challenging limitations, including providing for an efficient pass-on mechanism, addressing the embedded asymmetry in the payment process, avoiding multiple buy-ins and adverse behavioural incentives, managing extraterritorial impacts, and mitigating the additional market risks that will be created for all parties involved in the buy-in process, not least investors and intermediaries.

GMRA

ICMA, through its European Repo and Collateral Council (ERCC), will look to review the provisions in the Global Master Repurchase Agreement (GMRA) with respect to the impact of CSDR on repo. While a large portion of the repo market will be out of scope of the mandatory buy-in regime, longer term repos will be in scope. Furthermore, a significant increase in market risk caused by the regulation will arise as a result of the relationship between repo fails and cash bond fails, and the lack of contractual interoperability between CSDR mandatory buy-ins and GMRA mini close-outs.

[3] This is discussed further in ICMA's official position paper on CSDR Settlement Discipline (May 2017)

More information on CSDR Settlement Discipline can be found on the dedicated ICMA webpage: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-markets-regulation/csdr-settlement-discipline/

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Annex: cost analysis of mandatory buy-ins for European fixed income markets

Extracted from *ICMA Impact Study for CSDR Mandatory Buy-ins, February 2015*

Estimating the cost of implementing a mandatory buy-in regime is challenging due to the lack of granular data for both European bond and repo market activity. Furthermore, it is difficult to estimate what the impact of mandatory buy-ins will be on activity and the scale of the likely market contraction. However, it is possible to estimate the cost based on assumptions related to available data and based on current market structure and levels of activity.

Therefore, the approach in this analysis is to estimate the cost of mandatory buy-ins for bond markets based on €1 trillion annual volume. The total cost can then be calculated based on the estimated total volume of the European bond markets.

Bond market

The annual cost to the bond market (which will be borne by investors and issuers) per €1 trillion of volume is calculated using the flowing assumptions:

- The current split of secondary market volumes across the 3 main asset classes (applying Trax market data from 2014)[4] remains stable: roughly 89% for sovereign bonds, 4.5% for public bonds, and 6.5% for corporate bonds.
- The ratio of liquid to illiquid bonds is determined by the proposed MiFID II/R RTS.

Applying the survey data for increases in offer prices across the different asset classes, the overall cost to bond markets is estimated to be in the region of €1.4 billion per €1 trillion of annual volume.

Based on the Trax bond market data for 2014 (which shows a total transaction volume of €24 trillion), this would equate to an estimated annual cost of €33.6 billion).

[4] The Trax data used is the estimated European secondary bond market volumes for 2014, for all currencies, disaggregated by the asset classes used here. The data provided is denominated in USD as a base currency, but has been converted to Euros using the 2014 average exchange rate (ECB). ICMA gratefully acknowledges the terms of use of this data, and draws attention to the disclaimer pertaining its provision and use, which is published on Page 20 of this report.

<u>Estimating the cost to the bond market</u>

	Volume	Liquid	Illiquid	Offer increase liquid (cents)	Offer increase illiquid (cents)	Wtd avg offer increase (cents)	Cost
Sovereign	€888,401,825,280	99.5%	0.5%	9.7	20.9	9.76	€ 866,724,821
Public	€44,998,638,919	86.3%	13.7%	18.7	35.1	20.95	€ 94,257,749
Corporate	€66,599,535,801	80.1%	19.9%	51.2	99.5	60.81	€ 405,003,099
Total	€ 1,000,000,000,000						€ 1,365,985,669

Most estimates are that the total annual volume of the European bond market is significantly higher than €1 trillion. Trax data for 2014 shows bond market volumes of more than $32 trillion (€24 trillion)[5]. This seems high relative to other, more anecdotal estimates, but even if the true number is a fraction of this, or allowing for the inevitable contraction of market activity that mandatory buy-ins will prompt, the resulting annual cost will still run into several billions of euros.

[5] Trax further estimates that their data represents only 65% of all European bond market transactions