International
Capital
Market
Association

ICMA CSDR-Settlement Discipline Working Group

Meeting note from November 20 2018

Participating firms: *BlackRock, BNP Paribas, Citi, Commonwealth Bank of Australia, Credit Suisse, Danske Bank, Goldman Sachs, HSBC, Intesa San Paolo, Jefferies, JP Morgan, LCH, LSE Group, Morgan Stanley, Nomura, SocGen, Standard Chartered*
Observers: *Association of Global Custodians, EDMA Europe*

Part 1: Cash securities

1) **Update on adapting the ICMA Buy-in Rules as a contractual means to solve for the asymmetric buy-in/cash compensation payment differentials under CSDR** (as well as providing for implementation guidelines and best practice for bond markets)

Symmetrical settlement of the price differential

ICMA updated that ESMA was currently discussing with the European Commission the possibility of providing Level 3 guidance to the effect that it would be possible for firms to 'contract' to settle the buy-in price differential (the difference between the buy-in price and the original trade price) in either direction, depending on which is the higher. This is consistent with how (non-centrally cleared) bond market buy-ins work today. This should then allow ICMA to update its Buy-in Rules to support CSDR compliance, as well as establish market best practice, while also providing for symmetrical settlement of the buy-in price differential (subject to an external legal opinion on contractual enforceability).

It was noted, however, that ESMA had not previously considered the case for a similar symmetry in the payment of the cash compensation differential and had requested arguments and illustrations from ICMA to highlight why the same justification would apply.[1]

Updating the ICMA Buy-in Rules

It was asked whether it was envisaged that the revised ICMA Buy-in Rules would only be intended to apply during the CSDR extension period (ISD+7 business days in the case of fixed income). It was explained that there would potentially be at least two and possibly even three 'versions' (or rather applications) of the ICMA Buy-in Rules, which would be used depending on the circumstances. One version would likely be similar to the existing Buy-in Rules but provide for a shortened notification period (currently a minimum of 4 business days) to allow for the buy-in to be completed within the

[1] ICMA has since followed-up with ESMA on this point

extension period. Another version would mirror the CSDR regulatory provisions (to be used in the case of in-scope transactions) and would apply from the end of the extension period. There is also the potential for a third version of the Rules, which could provide continuity of the current framework for out-of-scope transactions. ICMA and its members would further need to consider how these different versions/applications might interact (say in the instance of pass-ons).

CCP buy-ins vs non-cleared bond markets

CCP buy-ins were flagged as, potentially, being very different to non-cleared buy-ins. It was pointed out that in the case of some cleared equity markets, buy-in processes are in fact asymmetrical (both for the buy-in and cash settlement mechanisms). However, participants noted that the scope for substantial price drops for equities, in relative terms, is generally much smaller than in the case of fixed income, also cleared transactions are netted, making transaction chains less relevant. From the perspective of non-cleared fixed income markets, it was agreed that symmetrical buy-ins/cash compensation payments were necessary to ensure the greatest efficiency and minimal friction in the buy-in process.

It was suggested, however, that maybe ICMA needs to be clear in its communication, particularly with ESMA, that its suggestions and recommendations for the CSDR buy-in and cash compensation process are from the perspective of non-cleared markets, and that market expectations may be different with respect to CCPs (particularly for centrally cleared equity markets). However, there was full unanimity that for a buy-in / cash compensation process to work efficiently for fixed income markets, it is imperative that the price differential be settled symmetrically, and that this should remain the underlying working assumption for establishing implementation solutions.

Extraterritorial application

The issue of extraterritorial reach of CSDR was raised and potential issues with respect to enforceability of contractual arrangements through the settlement chain (as envisaged by Article 25 of the RTS). ICMA clarified that it had not yet focused on the practicalities of contractual enforcement but agreed that this was a potentially challenging area that would need closer scrutiny in the months ahead. AGC reported that it is undertaking detailed work on this topic and agreed to keep ICMA and the Working Group informed of the outcomes.

2) Proposal for a pass-on mechanism under the CSDR framework

Draft proposal

ICMA talked through the draft proposal for a CSDR pass-on mechanism, which is based on the existing (and well established) pass-on mechanism used in the international (non-cleared) bond markets, under the ICMA Buy-in Rules. It was noted that for a pass-on mechanism to be effective, there are two essential requirements: (i) no asymmetry in the buy-in/cash compensation payments; and (ii) the ability to pass on the buy-in along a chain regardless of settlement dates.

Working off the assumption that the apparent asymmetry in the CSDR buy-in/cash compensation framework can be addressed (by contractual means), the main challenge to overcome is the fact that different trades in a transaction chain may have different intended settlement dates (ISDs). The way the regulation is framed, with rigid extension periods, suggests that each ISD in a transaction chain will trigger a buy-in, which could result in multiple buy-ins in the same security, in a relatively short timeframe, resulting from a single fail.

Discussion

ICMA explained that the draft proposal under discussion is intended to avoid multiple buy-ins across a transaction chain and would provide that **where parties have a failing purchase and a dependent failing onward sale, and where the settlement date for the onward sale is within the extension period associated with the failing purchase, there is no obligation to initiate a buy-in process against the failing purchase**. This will effectively pass the obligation to initiate the buy-in process to the next failed-to party in the chain.

Participants noted that the key benefit of this approach is that it is not essential to have overall visibility of the chain, and that parties only need to know that they have a purchase and an onward sale. Ultimately, the responsibility (or requirement) to initiate the buy-in process would always pass to the end of the chain. What is critical, however, is the speed at which the pass-on moves along the chain, both in terms of the original notice and confirmation of the execution. ICMA commented that this challenge exists today, but for the most part it rarely leads to timing issues. However, it was agreed that tightening best practice, and the potential automation of the process, would be critical in a market where buy-ins become more commonplace.

Participants questioned whether this would be possible under the regulation, given that CSDR is quite specific with respect to extension periods and when the buy-in process must start. Thus, there may not be a lot of room for ESMA to adopt a more flexible interpretation with respect to pass-ons. It was noted that under the proposal, in theory at least, the eventual buy-in could be delayed by up to seven days at each point in the chain, which may conflict with the original intention of the regulation.

It was anticipated that regulators may question whether buy-ins could be avoided indefinitely by the party at the end of a chain (the final purchaser) electing to sell securities on within the extension period. However, participants felt that this eventuality was highly unlikely as there was no incentive for the final buyer to do this. Firstly, they are likely to be an end investor, and so want their securities, and secondly, selling securities on so quickly, effectively as a forced seller, would be economically disadvantageous. It was agreed that this point would need to be highlighted in the proposal.

It was suggested that one possible refinement to the proposal could be a realignment of settlement dates through a chain to match with that of the final transaction. The challenge, however, would be to ensure that every firm in the chain is both aware of the new ISD and is willing to agree to change it. It would also mean adjusting the original price agreed for each amended transaction (to account for accrued interest and funding costs). Furthermore, it may require multiple amendments as the chain is extended by new transactions. It was suggested that while this approach would seem to be consistent with the regulation, it would be operationally onerous and likely to increase the risk of unmatched trades (so undermining settlement efficiency).

CCP buy-in practices were briefly discussed to see if there was anything that could help inform a pass-on mechanism for non-cleared trades. It was suggested that having overall visibility of a transaction chain may effectively allow for a form of settlement 'netting', by connecting the start and the end of chain, and effectively 'removing' other parties in the chain from the buy-in process. However, it was not clear how this could be achieved logistically.

The question of extraterritoriality was raised with respect to pass-ons, and the potential implications of having out-of-scope transactions in the chain. It was suggested that the proposed mechanism (similar to present) could potentially work across a contractual transaction chain (say, under the ICMA Rules).

Next steps

The Group agreed that the current proposal was perhaps optimal and that there was little downside is sharing it with ESMA. Even if it was not possible under the limitations of the regulation, it would at least highlight the key challenges and perhaps move everyone in the direction of the next optimal solution. ICMA agreed to refine the proposal, addressing some of the issues flagged in the discussion, before sharing it with members for further comments. ICMA will also share with AFME and other associations in the hope that it could become an industry proposal.

Action point: ICMA to refine the pass-on mechanism proposal and share with the WG and other industry associations.

Part 2: Repo & SFTs

3) Points for clarification from ESMA

ICMA explained that it intended to take a number of suggestions and recommendations to ESMA in the coming weeks or months to help inform much needed Level 3 guidance on a number of practical issues around applying the CSDR buy-in framework to SFTs. The list was by no means exhaustive, and more challenges and ambiguities were likely to be raised over time. Furthermore, it would be essential to align with other associations, in particular ISLA, with respect to any recommendations for ESMA.

a) Open SFTs

Participants were unanimous in the view that open transactions are effectively rolling one-day trades and therefore should be out-of-scope of mandatory buy-ins. It was further argued that bringing them into-scope would only lead to a change in market practice whereby firms stopped using open trades and instead rolled short-dated fixed-term trades – which would result in operation inefficiencies and increased settlement risk.

All agreed that the same argument should apply in the case where an open trade reaches 30 business days. If these open trades were to be brought into scope at this point, it would simply result in parties closing and re-opening trades before they reached the 30 days, again resulting in operational inefficiency and increased settlement risk.

It was felt that on the same basis, any SFT that can technically be closed in under 30 business days should be considered out-of-scope (e.g. a 29-day 'evergreen').

Participants agreed that the treatment of open SFTs and, similarly, short-dated evergreen structures should be clarified by ESMA in its Q&As, and that ICMA should recommend that they be treated as out-of-scope of mandatory buy-ins.

A point was made about the inherent contradiction between CSDR, which effectively incentivizes the shortening of SFT durations, and LCR and NSFR which are intended to increase SFT durations. It was felt that this conflict of regulatory objectives needed to be articulated more clearly to regulators.

b) How to buy-in the start-leg of an SFT

The discussion began by questioning whether start-legs of SFTs are intended to be in scope of mandatory buy-ins. It was felt that whilst there is no clear distinction in either the Level 1 or the RTS, the fact that CSDR provides for an exemption in the case "where the timeframe of those operations is sufficiently short" suggests that the regulation is intended to apply to start-legs.

It was pointed out that start-legs on term SFTs that fail for 7 days or longer were likely to be outliers, and that buy-ins against SFT start-legs would be relatively rare. However, it was agreed that having appropriate guidelines in place for this eventuality was still important.

ICMA ran through the complications of applying cash buy-ins in the case of a failing start-leg. In theory, if one viewed an SFT as two separate transactions (a purchase and a forward sale), one could argue that it is possible to buy-in the start-leg, replacing it with an outright transaction, while the end-leg (the forward transaction) remains intact. However, this becomes complicated in the case that the buy-in results in cash compensation. In this scenario, what would happen to the end-leg? Furthermore, the costs normally associated with a buy-in (even assuming that the apparent asymmetry can be resolved) are significant and vastly incommensurate with the economics of an SFT.

It was suggested that a good starting point for trying to establish how buy-ins should be applied to SFTs was to refer to how existing legal frameworks (GMRA and GMSLA) provided for failing SFTs. It was noted that in the case of failing start-legs there is no 'buy-in-like' mechanism, and the only recourse open to the failed-to party is to cancel the trade. The remedy for end-legs, however, was different in that a 'mini close-out' provision allowed for cancelation and a claim for replacement costs, which is some respects resembled a buy-in-like mechanism. The precise provisions were also slightly different, depending on the contract under which the parties are transacting.

ICMA asked participants for views on the suggested proposal for failing start-legs resulting in automatic cash compensation, based on the replacement cost of the SFT rather than the market value of the underlying securities. It was felt that while this was potentially preferable to an outright buy-in in the underlying securities, it was still difficult to assess what the replacement value should be, given the number of variables, not least the fact that SFT pricing is largely counterparty specific.

One suggestion was for a pre-determined formula for cash compensation in the case of failed start-legs once they reach the end of the extension period. This would at least provide for predictability and could be commensurate with the risk of the SFT.

It was agreed that the complexities of buying-in SFTs at the start were unlikely to be resolved easily or quickly, and that more time and industry discussion would be necessary to develop an appropriate recommendation for ESMA.

c) SFTs with haircuts

It was agreed that in terms of settling any buy-in or cash compensation differentials in the case of a cash buy-in against a leg of an SFT, it would be essential to make an adjustment for any haircuts applied to the SFT. It was suggested that ICMA draft a proposal for ESMA Q&As with worked examples.

Action point: ICMA to draft proposals for ESMA Level 3 guidance with respect to open trades and haircuts, to be shared with members and also ISLA.

Other issues

It was asked whether ICMA had considered the application of mandatory buy-ins to physically settled derivatives, such as bond forwards. It was decided that since this would impact transactions traded under ISDA agreements, ICMA would flag the issue with ISDA with a view to a potential collaborative approach on any related work.

Ends

Andy Hill, November 2018