CSDR Settlement Discipline
An ICMA Position Paper
May 2017

Overview

This paper sets out the formal position of the International Capital Market Association (ICMA) with respect to the Settlement Discipline (SD) regime provided for in the CSD-Regulation (CSDR), [1] specifically in the context of fixed income markets. This position paper was prepared in close consultation with the ICMA CSDR/Buy-in Working Group, which is a sub-group of the ICMA Secondary Market Practices Committee (SMPC), and which constitutes participation from the broad representation of ICMA's diverse sell-side and buy-side members active in the international fixed income markets.[2] The focus and representation of the Group is primarily at the trading and market-risk level, while also drawing on members' post-trade expertise.

ICMA is fully supportive of measures to improve settlement efficiency in the European fixed income markets, particularly where this adds to the overall stability and effective functioning of the market. The ICMA Secondary Market Rules and Recommendations (the 'Rules') provide mechanisms to encourage timely settlement as well as to protect parties in the event of settlement fails. For example, the ICMA buy-in procedure is the long-standing remedy available in the international cross-border fixed income markets for non-defaulting parties to enforce delivery of securities in the event of a fail. The recent amendments to the buy-in and sell-out procedures illustrate ICMA's commitment to maintaining an efficient and effective risk-mitigation tool for non-defaulting parties in the event of fails and to support orderly markets.

ICMA's position on CSDR-SD relates to its two key components: (i) cash penalties for settlement fails; and (ii) the mandatory buy-in regime. **Essentially, ICMA proposes that the cash penalties for bonds should be increased when implemented in 2019, while mandatory buy-ins should not be implemented.** ICMA firmly believes that a well calibrated penalty mechanism will effectively achieve the goal of improving and sustaining settlement efficiency, negating the need for the mandatory buy-in mechanism. The mandatory buy-in mechanism should only be implemented as a last resort, given an assessment of the effectiveness, and possible further recalibration, of the cash penalty mechanism.

(i) In principle, ICMA is supportive of the cash penalty regime, particularly to the extent that it is fully harmonized, utilizes a single reference price for each security, and consists of both a penalty and compensation component. ICMA believes that a cash penalty regime for fails is particularly relevant in a negative or low interest rate environment, when the normal economic incentives for settlement efficiency become less effective. However, the potential effectiveness of a penalty regime rests not only on its design, but also on the penalties being applied, particularly with respect to the prevailing interest rates. ICMA feels that the penalty rates currently proposed in CSDR for bonds (0.1bp for

[1] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories
[2] The Working Group also contains members and representatives of ICMA's European Repo and Collateral Council (ERCC) and its Asset Management and Investors Council (AMIC) Executive Committee

SSA and 0.2bp for non-SSA, per business day – approximately 0.25% and 0.50% annualized) are too low to be effective, particularly with respect to 'specials' rates observed in the repo market, or the costs of utilizing the ICSD 'autoborrow' facilities. **ICMA proposes the penalty rate be increased to 1bp (approximately 2.50% annualized) for all bonds (except SME debt instruments).** This penalty rate should be reviewed on a periodic basis in light of settlement efficiency rates as well as prevailing interest rates.

(ii) **ICMA is firmly opposed to the implementation of the CSDR buy-in regime with respect to the European non-centrally-cleared fixed income markets**. It is ICMA's belief that the design of the buy-in regime is inherently flawed, that it creates unnecessary and unintended risks for both sellers and buyers, and that its implementation will be a direct threat to the orderly and efficient functioning of the European bond markets. ICMA therefore believes that the implementation of the mandatory buy-in regime should only be considered if an appropriately calibrated penalty regime proves ineffective in improving and maintaining bond market settlement efficiency.

ICMA would further maintain that these recommendations are consistent with the aims of the EU's Capital Markets Union (CMU) initiative that support the development of an efficient and liquid pan-European corporate bond market.

Regulatory context: Level 1

Article 7 of CSDR (Regulation (EU) No 909/2014), which became law in 2014, provides the regulatory outline for ***measures to address settlement fails*.**

Paragraph 2 lays out the requirement for EU central securities depositories (CSDs) to establish a **penalty mechanism** *which will serve as an effective deterrent for participants*[3] *that cause settlement fails*. The regulation further specifies that the penalties are to be applied on a business-day basis, and that they cannot be a source of revenue for the CSD.

Paragraph 3 provides for a **buy-in process** to be initiated in the event that settlement does not take place within four-days of the intended settlement date (although it does not explain what a buy-in is; just that it should happen):

Without prejudice to the penalty mechanism referred to in paragraph 2 and the right to bilaterally cancel the transaction, where a failing participant does not deliver the financial instruments…to the receiving participant within 4 business days after the intended settlement date ('extension period') a buy-in process shall be initiated whereby those instruments shall be available for settlement and delivered to the receiving participant within an appropriate time-frame.

Paragraph 4 provides for two exemptions with respect to the timing of the buy-in:

[3] Participants of CSDs are its members, and include settlement agents and custodian banks, as well as other CSDs. In many cases, the CSD participant will not be the trading entity.

(a) Based on asset type and liquidity of the financial instrument, the extension period can be increased from four business days to seven business days, *where a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned;*

(b) In the case of trades involving several transactions, including securities financing transactions (SFTs), the buy-in process does not apply shall *where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective.*

With respect to the possibility of a 7-day extension period, the thinking at the time was that this would relate to the (yet un-finalized) liquidity calibration for the asset being bought-in as determined by MiFID II/R (as specified in paragraph 15(d)).

Meanwhile, buy-ins would not apply to SFTs where the term of the SFT (i.e. the time between the start and end legs of the transaction) was shorter than the timeline from the intended settlement date to the eventual settlement of the buy-in.

Paragraph 5, however, states that these exemptions do not apply in relation to *transactions for shares*[4] where they are cleared by a CCP.

Paragraph 6 outlines when the buy-in differential (the difference between the original transaction price and buy-in price) shall be paid: *no later than on the second business day after the financial instruments have been delivered following the buy-in.*

However, it also suggests that this differential is only paid, to the *receiving participant* from the *failing participant, where the price of the shares* [securities?] *agreed at the time of the trade is higher than the price paid for the execution of the buy-in)*. This is notable for three reasons:

(i) In a normal buy-in, where the original transaction price is higher than the buy-in price, the differential is paid by the purchasing (*receiving*) party to the selling (*failing*) party (and vice versa where the original transaction price is lower than the buy-in price). At first read, this would appear to be an error, and that the direction of the payment between parties has been transposed in the text.

(ii) Another possible interpretation of this is that the buy-in process envisaged involves the buy-in agent delivering the securities to the selling (*failing*) party, rather than to the purchasing (*receiving*) party. However, apart from being an unorthodox (and relatively inefficient) buy-in process, this still does not explain why there should be a payment of the differential from the failing party to the purchasing party.[5]

(iii) In either scenario, there seems to be no provision for the differential payment to be made by the purchasing (*receiving*) party to the selling (*failing*) party, which would ordinarily need to happen in the event of the buy-in price being lower than the original transaction price.

---

[4] It is not clear, but it is assumed that in this context *shares* are intended to mean all securities, including bonds

[5] If this is what the drafters had in mind, then there should be no payment between the parties: the defaulting party would simply deliver the bought-in securities to the non-defaulting party at the original transaction price.

Paragraph 7 provides that where the buy-in either fails or is not possible, the *receiving participant* can choose either to be paid **cash compensation** or to defer the buy-in to an appropriate later date (*'deferral period'*). If the buy-in is still not successfully settled by the end of the deferral period, then cash compensation is paid.

Paragraph 7 also outlines when the cash compensation shall be paid (no later than two days after the buy-in or deferral process), but only specifies that the cash compensation is paid *to the receiving party,* and, similar to the buy-in differential payment process outlined in paragraph 6, does not provide for the possibility of the cash compensation being paid in the opposite direction.

Paragraph 10 provides for the buy-in process for transactions that are traded on a trading venue or cleared by a CCP. In the case of cleared-transactions, the CCP is responsible for executing the buy-in. For non-cleared transactions executed on a trading venue, the venue has to include in its rules an obligation for its members and participants to apply the buy-in measures as outlined in the regulation.

Paragraph 11 provides an exemption in the case where the failing participant is a CCP (i.e. the mandatory buy-in regime does not apply to CCPs where they are the failing party).

The regulation requires ESMA to draft and submit regulatory technical standards (RTS) with respect to the buy-in process (including appropriate timelines) and the cash penalty mechanism (with the latter being adopted by means of a delegated act).

At the time, the CSDR-SD regime was expected to be implemented by early 2016.

<u>Level 1: discussion</u>

With respect to the proposed **penalty mechanism**, ICMA was keen to support this regulatory initiative. However, ICMA, and others, stressed that the characteristics of a successful cash penalty regime would include:

- A harmonized mechanism applied across all in-scope CSDs.
- Both penalty and compensation elements (with the penalty charged to the failing party being distributed to the non-defaulting party).
- The penalty/compensation mechanism to be applied at the individual transaction level.
- A single reference price for each security (per reference date) to ensure standardization of the penalty amount across all CSDs.
- Appropriately calibrated, and ideally dynamic, penalty rates to ensure both the right economic disincentives to failing, as well as for non-defaulting parties to utilize the SFT markets.

With respect to the proposed **buy-in mechanism**, ICMA, as well as many other market participants and representative bodies, highlighted what appear to be a number of flaws or unnecessary limitations in the buy-in process as outlined in the Level 1:

- The fact that the buy-in process is mandatory, rather than discretionary, seems to undermine the integrity of the mechanism as an effective risk management tool for the non-defaulting party.
- Whereas buy-ins are generally executed by the non-defaulting trading entity against the defaulting trading entity, the regulation frames the buy-in process in terms of CSD *participants,* which in most cases will not be the actual trading entities.
- Applying buy-ins to the start-legs of SFTs is unorthodox and could create disproportionate risks and so a disincentive to repo and securities lending.
- The inability to buy-in a failing CCP creates additional risks for parties that are transacting in both the cleared and non-cleared markets.
- The automatic default to cash compensation in the event of a buy-in being unsuccessful would disadvantage purchasing parties who could no longer be certain of their exposure to purchased securities until they settled.
- The lack of flexibility in the timing for initiating the buy-in process creates the need for multiple buy-ins in the case of a single fail causing a chain of market fails.
- The asymmetry with respect to the direction of the payment of the buy-in differential or cash compensation unfairly (and unpredictably) penalizes the selling party (including intermediaries who are not the originator of the fail) and benefits the purchasing party, which creates additional risks and so disincentives to market-makers and intermediaries.

These points, and others, were highlighted in ICMA's response to ESMA's Consultation Papers on the draft Technical Standards and Technical Advice in February 2015.

Level 2

ESMA's draft technical advice for the **penalty mechanism**, published in December 2014, were largely consistent with ICMA's recommendations, and the market responses to the related Consultation Paper were broadly supportive of the proposed mechanism. However, in its response, ICMA noted the challenge in calibrating appropriate penalty rates:

ICMA appreciates that in drafting the proposed approach regarding categories of financial instruments and the penalty rates, ESMA needed to consider a simple, easily implementable, cost effective approach, while balancing the sufficient incentives and deterrents to cure fails. From this perspective, it is very difficult to design a mechanism that will be appropriate for every security under every market condition.

ICMA further recommended *a periodic review of the applied rates (and possibly categories of instruments) and a possible recalibration of the model to improve the overall impact on settlement efficiency.*

ESMA's draft technical standards with respect to the **buy-in mechanism** only served to highlight the inherent flaws and limitations (as well as possible errors) of the Level 1 regulation. ICMA's was one of many detailed and technical responses that pointed out how the proposed mechanism was not only difficult, if not impossible, to implement and enforce from an operational perspective, but that it also increased the operational and market risk of entities not party to the original transaction (including custodians, settlement agents, CSDs, and even trading venues),[6] as well as creating additional risks for both the buying (*receiving*) and selling (*failing*) parties to the transaction.

In order to inform its response, ICMA also conducted a market impact analysis[7] of the proposed mandatory buy-in regime, which it published in February 2015. Based on a survey of fixed income market-makers, the study illustrates how secondary European bond and financing markets will reduce significantly, once the regime is implemented, while bid-offer spreads will also widen dramatically. The results suggest that even the most liquid sovereign bonds will see bid-offer spreads double, while secondary markets in less liquid corporate bonds may effectively close. The survey further suggests that for many less liquid bonds, including sovereign and public issues, market-makers will retrench from providing liquidity altogether.

Many market participants and representative bodies, including ICMA, called for at best the Level 1 to be revised with respect to the buy-in regime (and ideally for mandatory buy-ins to be removed altogether), or at worst for the Level 2 to be re-drafted, particularly with respect to the entities responsible for executing the buy-in (ideally 'trading level' only) and a more comprehensive exemption for SFTs. There were also many calls for a suitable delay (at least 18 months) in the implementation for CSDR-SD given the significant technological build and investment that would be required to support the implementation of both the penalty and buy-in mechanisms.

Mandatory buy-ins: Level 2 redux

Following the responses to the December 2014 Consultation Paper, as well as ongoing dialogue with the market, both by ESMA and the European Commission, it became apparent that the draft RTS proposed in the December 2014 Consultation Paper, which were closely aligned to the Level 1, could not be implemented without significant market disruption and a broad increase in the overall market and operational risk of participants, including custodians, settlement agents, CSDs, and trading venues, as well as the trading parties themselves.

Following close consultation between ESMA and the European Commission, in June 2015 ESMA published a Consultation Paper on the RTS for the ***operation of the buy-in process*** under CSDR. The paper presented three options for the buy-in process:

(i) Trading level execution
(ii) Trading level with fall-back (to the CSD participant) option execution
(iii) CSD participant level execution

[6] It was highlighted that where entities other than the trading parties are bearing the risk of the buy-in, they may require the collateralization of settlement risk by their members
[7] ICMA is not aware of either the European Commission or ESMA conducting a market impact analysis of CSDR-SD, either before or after the Level 1 was passed into law

Other than the different options for the entity executing the buy-in, the mechanism itself was largely unchanged from the previous draft RTS, including the timings and scope of the buy-in.

In its response, ICMA, in line with other market representative bodies, again argued that a mandatory buy-in regime would be disruptive for market efficiency and liquidity, pointing to the flaws and limitations of the Level 1. However, ICMA, in consensus with most respondents, also responded that in terms of the options presented in the Consultation Paper, ***trading level execution*** was the least worst option. ICMA and others further pointed to the need for a broader exemption of SFTs, as well as the importance of a lengthy delay to implementation.

In February 2016, ESMA finally published the revised draft RTS for the operation of the CSDR mandatory buy-in. Given the flaws and limitations of the Level 1, and the concerns raised in response to the earlier draft RTS, the revised draft RTS attempt to strike a difficult balance between consistency with the Level 1 and minimizing the potential for unintended adverse market impacts. Of note, the revised RTS, for the most part, places the responsibility for executing the buy-in with the trading level entity. Other key amendments include affording the maximum possible extension period for fixed income (7-days), without reference to the security's MiFID II/R liquidity calibration, and an exemption for SFTs with terms of less than 30 business days. ESMA also proposes a 24-month delay to implementation to allow for the necessary IT development across the industry that will be required to support the process.

A summary overview of the draft RTS is provided in the Annex to this paper.

Acceptance of the Level 2 for CSDR-SD

In March **2017** a package of regulatory technical standards for CSDR was published in the Official Journal of the European Union. This included the RTS for *the parameters for the calculation of* ***cash penalties for settlement fails*** *and the operations of CSDs* [central securities depositories] *in host Member States*. This is largely in line with the draft technical standards published in December 2014, and meets most of the criteria recommended by ICMA and others to support an effective penalty regime. The RTS also finalizes the penalty rates that are to be applied from implementation. These are summarized below, along with the approximate equivalent annualized cost.

Type of fail/security	Penalty Rate	Equivalent annualized cost
Liquid shares	1.00 bp	2.50%
Illiquid shares	0.50 bp	1.25%
SME growth instruments (non-debt)	0.25 bp	0.625%
SSA bonds	**0.10 bp**	**0.25%**
Non-SSA bonds	**0.20 bp**	**0.50%**
SME debt instruments	0.15 bp	0.375%
All other financial instruments	0.50 bp	1.25%
Fail due to lack of cash	Official overnight rate	Official overnight rate (≥0%)

With respect to implementation, while the regulation entered into force 20 days after its publication in the Official Journal the RTS provides for a two-year delay before implementation. Furthermore, it is intended to be implemented at the same time as the other elements of Article 7, including mandatory buy-ins

As yet, however, the draft RTS for the buy-in mechanism have still not been accepted by the co-legislators.

Discussion

Penalty mechanism

Feedback from the ICMA membership suggests that a standardized and harmonized cash penalty regime for settlement fails is, in principle, a broadly welcomed regulatory initiative, particularly in a low-to-negative interest rate environment. However, the general reaction of ICMA's members is that the penalty rates, with respect to fixed income, are too low to make any meaningful impact on settlement efficiency (citing the US treasury market TMPG Fails Charge of 3%). Certainly, the CSDR penalty rates would appear to be significantly lower than the current 'specials' repo-rates observed in the European sovereign and corporate bond markets. However, this also needs to be viewed in light of already relatively high settlement efficiency rates across the European bond markets, despite negative Eurozone interest rates, and where most fails seem to be attributed either to structural issues (such as CSD interoperability)[8] or to reduced liquidity in the repo and securities lending markets.[9]

In consultation with its members, ICMA proposes that in the current interest rate environment applying a penalty rate equivalent to **2.50% annualized** (i.e. **1bp per business day** of market value)

[8] It is widely expected that initiatives such as Target2Securities, or enhancements to the 'bridge' between the two ICSDs, will have positive impacts on European settlement efficiency rates.
[9] As discussed later in this paper, one of the ironies of the mandatory buy-in regime is that it will become a further deterrent to lending securities, with the likely outcome of worsening settlement efficiency rates.

for all bonds (with the exception of SME debt instruments) would be sufficiently high to incentivize settlement efficiency, while not being so punitive as to impact adversely market liquidity. Furthermore, to a certain degree, penalty rates can be seen to set a 'soft ceiling' on repo or securities lending rates, with the result that a higher ceiling allows for the opportunity to earn larger spreads from lending securities, and so can improve liquidity in the repo and securities lending markets by increasing the incentive for holders to lend their securities.

Given that cash penalties also have to be considered in light of prevailing interest rates,[10] and so should ideally be dynamic (such as the TMPG Fails Charge), ICMA would further recommend that the penalty rate for bonds be reviewed regularly, at least on an annualized basis, or following significant changes in euro or other key interest rates.

Furthermore, ICMA maintains that an appropriately calibrated penalty mechanism will negate the need for a mandatory buy-in regime.

Mandatory buy-in mechanism

While ICMA welcomes the work by ESMA to improve the draft RTS and to attempt to address some of the flaws in the Level 1, in particular with respect to the buy-in being executed at the trading level and the exemption for SFTs, both of which can be viewed as constructive revisions. However, ICMA believes that the mechanism is still fundamentally flawed, largely as a result of the Level 1, and that a number of key issues still render the CSDR buy-in regime unfit for purpose with respect to European fixed income markets.

a) *The mandatory nature of the buy-in process*

In the non-cleared fixed income markets, buy-ins are generally a discretionary mechanism available to purchasing parties in the event of a fail, and are effectively a risk management tool for trading entities, rather than a form of penalty mechanism.[11] This allows trading entities to exercise discretion as to when to initiate a buy-in process, and so enables them to take into consideration a number of critical factors, including the liquidity of the security, their relationship with the failing counterparty, any contingent onward deliveries, as well as the market conditions for executing the buy-in. This also helps to explain why buy-ins in the European fixed income markets are currently relatively rare occurrences.

Mandating that the non-defaulting party *must* initiate a buy-in process, on a mandated date and within a mandated time period, not only creates additional risks for sellers of bonds, in particular market-makers and other liquidity providers, it also undermines the mechanism as a risk-management tool for the purchaser. Furthermore, given the mandatory provision for cash

---

[10] The 'natural' cost of failing to deliver is the overnight rate at which the failing party must fund the securities until they make good on the delivery (and while the purchaser still holds title and so the economic benefits of the security). This holds true for any cash settled security, regardless of asset class.

[11] In the non-cleared European fixed income markets the most commonly used buy-in mechanism is the ICMA buy-in procedures under the ICMA Secondary Market Rules and Recommendations

compensation[12] in the event of the buy-in being unsuccessful, the purchasing party mandated to initiate a buy-in process cannot be certain that they will ever take delivery of their securities. Instead, they will face a far higher risk that they will not, with the likelihood of being 'cashed-out' of the trade at a reference price over which they have little or no control. This is particularly unhelpful in the case where the entity is purchasing bonds to match specific liabilities or commitments, or where the purchase is part of a package of contingent transactions, such as a spread trade.

b) The inability to pass-on risks and costs against a failing SFT

There is usually no buy-in remedy available for failing SFTs, given that these are (usually short-term) financing transactions, rather than outright purchases or sales. In most cases, particularly with respect to the start leg of an SFT, a buy-in would be an inappropriate remedy. Standard SFT agreements, such as the GMRA or GMSLA, instead provide for the possibility to cancel a failing SFT and for the non-defaulting (borrowing) party to be compensated for the loss of interest that would have been earned on that SFT had it settled (up to the point of cancelation). However, in the event of a failing end leg of an SFT (i.e. the return of the securities to the lender), the agreements provide for the non-defaulting party to claim for the cost of replacing the underlying (failing) security (through a process known as a 'mini-close-out'). While this is, in some respects, comparable to a buy-in, contractually and technically it is not the same. Furthermore, where a failing SFT may be the cause of failing outright sale, there is no legal provision for 'passing-on' any costs arising from a buy-in[13] through the mini-close-out process.

This is particularly pertinent for market-makers who often rely on the repo market in order to sell bonds to their customers, and who will borrow the bonds until they are able to purchase them and cover their short-sale. In the event that their repo fails, causing their sale also to fail, the repo agreement will not protect them in the event that the purchasing party issues them with a buy-in. This is a broadly understood risk for market-makers and other liquidity providers; however, given the relative infrequency of buy-ins, it is generally considered to be a small and manageable risk. In a mandatory buy-in regime, however, this risk will increase significantly, particularly for bonds where the repo market is relatively thin or illiquid.

This lack of interoperability between buy-ins and SFT close-outs also poses a risk for lenders of securities. For example, an investment firm that repos-out its bonds then subsequently sells those bonds, faces the risk that the borrower of the bonds does not return them on time, so causing the sale to fail. In the event that the investment firm is subsequently bought-in, they may be unable to recoup any cost arising from the buy-in through exercising a close-out against the failing repo counterparty. Again, given the relative infrequency of buy-ins, this risk is generally considered to be small by lenders of securities or their agents, and so manageable. However, in a mandatory buy-in

[12] It could be argued that the option for the non-defaulting party to enforce a cash compensation remedy might be beneficial. However, mandatory cash compensation clearly undermines the ability of the non-defaulting party to manage their risk.

[13] While conventional buy-in mechanisms are not designed to penalize the failing party, the failing party often incurs a cost from the buy-in. This cost arises because buy-ins are usually exercised at a premium to the current market price (the 'buy-in premium'), and the cost is effectively the difference between the buy-in price they receive and the subsequent sale price or mark-to-market.

regime these risks heighten significantly, and should provide a strong disincentive to lending securities, particularly for less liquid instruments, such as corporate bonds.

c) The inability to pass-on the buy-in against a CCP

An important feature of any buy-in mechanism is the ability to 'pass-on' a buy-in in the event of connected trades ('chains'), particularly where a single fail may be causing multiple fails throughout a settlement chain. Such chains are quite common in fixed income markets, where broker-dealers often act as principal intermediaries to an investor's sale or purchase of bonds, with the position subsequently being recycled through other dealers or investors. Where a party receives a buy-in against a failing sale, which in turn is being caused by a matching failing purchase, it is important that they should be able to pass-on the buy-in to the party failing to them (and similarly, the buy-in can be passed along the chain right up to the initiating fail). Without the ability to pass-on buy-ins, a buy-in would need to take place at every step in the chain: in other words, a single fail will result in multiple buy-ins being initiated. Apart from being highly inefficient, this would also pose a threat to market stability.

While the draft RTS allows for the possibility of a pass-on (although it does not explicitly provide for a pass-on mechanism), it does not allow for a buy-in to be issued against a failing CCP (consistent with the Level 1). Thus, in the case where one or more CCP is part of a settlement chain that also involves non-cleared transaction, a single fail will result in at least two distinct buy-ins needing to be initiated.

d) The inflexibility of the timing for initiating the buy-in

OTC buy-ins, such as the ICMA rules, generally allow the non-defaulting party to issue a buy-in at their discretion any time after the intended settlement date. This is particularly helpful in the event of failing settlement chains (see previous point) and the use of the pass-on mechanism. For example, a market-maker, or other principal intermediary, may purchase a bond from a customer (for standard settlement), hold the position on their own trading book overnight, then sell the bond to another customer the next day (again for standard settlement). In the event that the purchase fails, causing the subsequent sale to fail, the non-defaulting party is able to issue the market-maker with a buy-in at any time of their choosing (potentially on the first day of the fail). The market-maker is then able to pass-on the buy-in to the original failing party.

However, this scenario does not work under the mandatory buy-in regime. Under the regulation, the market-maker would be required to issue a buy-in to the original customer after the trade has failed for seven days. In turn, the non-defaulting customer at the end of the chain would have to issue the market-maker with a buy-in *the next day*. Thus, the regime would require two buy-ins, on consecutive days, as a result of a single fail. In longer chains, with different transaction and settlement dates, a single fail could result in multiple buy-ins over several days, potentially causing significant and unnecessary market disruption.

e) The asymmetry of the payment for the buy-in or cash compensation differential[14]

As already discussed, a buy-in mechanism is not a penalty mechanism; rather it is a risk-management tool that allows the non-defaulting purchaser of securities to enforce delivery of those securities without any additional cost or financial loss. Accordingly, it is usual for the differential between the buy-in price and the original transaction price (including any associated costs) to be settled between the defaulting and non-defaulting parties. This payment can be made in either direction, depending on whether the buy-in price is higher or lower than the original transaction price. This helps ensure that the original economics of the trade are not changed.

The CSDR buy-in mechanism only provides for the payment of the buy-in (or cash compensation) differential to be paid by the defaulting party to the non-defaulting party (in the case where the buy-in or reference price is higher than the original transaction price). This asymmetry means that in the event of the buy-in (or reference) price being lower than the original transaction price, the economics of the original trade are altered, with the non-defaulting party making an additional profit (essentially the price differential) at the expense of the defaulting party. From an economic perspective, this asymmetry is essentially the same as any seller of securities also writing a free at-the-money put option for the purchaser, which becomes active in the event of the buy-in.

This asymmetry (the so-called 'CSDR put') is yet another additional, and largely unquantifiable and unmanageable, risk that would be created for sellers of securities (including intermediaries[15]), and is likely to have a significant detrimental impact on both market liquidity and efficiency.

It soon becomes clear that the mandatory buy-in regime under CSDR, even if executed at the trading level, not only creates significant additional risk for both liquidity providers and liquidity takers, it is likely to be hugely disruptive with respect to the smooth and efficient functioning of Europe's fixed income markets.

Conclusion

ICMA is largely supportive of a standardized, harmonized, cash penalty mechanism for settlement fails in the European fixed income markets, particularly in a low interest rate environment, when the natural economic incentives for settlement efficiency are less effective. To that extent, ICMA broadly welcomes the CSDR penalty mechanism. However, for any mechanism to be effective, it is essential that the penalty rates being applied are appropriately calibrated. Ideally rates should be high enough to dis-incentivize failing, but not so high as to impact market liquidity, while also being at a level that encourages the lending of securities in the SFT markets. ICMA, in consultation with its members, believes that the penalty rates published in the final RTS with respect to fixed income are too low,

[14] Also see: CSDR Mandatory Buy-ins: An illustration of the problems arising from the asymmetric treatment of the payment of the buy-in or cash compensation differential, ICMA, March 2016

[15] One of the stranger outcomes of this asymmetry is in the case of a principal intermediary who has bought and sold securities, presumably for a spread. If they subsequently find themselves in a fails chain, through no fault of their own, in the event that the resulting buy-in price is lower than their original purchase price, both their trades will be cancelled, and their profit wiped out.

and that a more appropriate rate would be 1bp per business day (approximately 2.50% annualized) for all bonds (with the exception of SME debt instruments). An appropriately calibrated rate would also negate the need for a mandatory buy-in mechanism.

Meanwhile, ICMA remains firmly opposed to the implementation of the CSDR mandatory buy-in mechanism, which it views as inherently flawed. If and when the mandatory buy-in regime is implemented, it is clear that this will not only create significant additional and unnecessary market and operational risks for both sellers and buyers (as well, quite possibly, to non-trading level entities), but it will almost certainly have detrimental impacts for bond market efficiency and liquidity.

Accordingly, ICMA's position with respect to CSDR-SD and the European bond markets is that increasing the cash penalty rates for fixed income securities at implementation will produce the desired overall objective of CSDR-SD of improving and maintaining settlement efficiency. Following an assessment of the effectiveness of the cash penalty mechanism, as well as other initiatives to improve settlement efficiency rates, the authorities will be in a position to determine whether the implementation of the mandatory buy-in regime, with its adverse impacts for market stability and liquidity, will be necessary.

Prepared by Andy Hill, ICMA

Annex

Summary of the draft RTS for CSDR mandatory buy-ins

Execution level

- For transactions not cleared by a CCP, the **trading parties** that originally concluded the relevant transaction should be responsible for executing the buy-in.
- The failing trading party is responsible for paying the buy-in price differential or cash compensation, and associated costs.
- In the event of a **buy-in**, where the failing trading party does not pay the price difference or costs related to the buy-in, **the failing participant will be liable**.[16]
- In the event of cash compensation, where the failing trading party does not pay the price difference or costs related to the cash compensation, **the failing participant will not be liable**.
- To avoid unnecessarily increasing risk, trading venues and CSDs are not actively involved in the execution of buy-ins.
- The text explicitly allows parties in a settlement chain to “coordinate their actions” in order to avoid multiple buy-ins, which seems to provide for **a pass-on mechanism**.

Timeframes for the buy-in process

- The buy-in process shall be triggered **7 business days after intended settlement** date for all financial instruments except equities. Buy-ins for equities will be triggered either 4 business days (liquid) or 7 business days (illiquid) after intended settlement date, as determined by MiFID II liquidity calibrations.
- The timeframe to deliver the instruments being bought-in (i.e. the time from the start of the buy-in process to settlement of the buy-in) is also **7 business days**, except for liquid equities (4 business days).
- Where the buy-in fails or is not possible, and where the **receiving trading party** chooses to defer the buy-in, the timeframe outlined for the original buy-in process will also apply (7 business days for all instruments other than liquid equities).

Payment of the buy-in or cash compensation price difference and costs

- Where the buy-in is successful, the difference between the buy-in price and the original transaction price is paid by the failing trading party, but only in the event that the buy-in price is higher than the original transaction price.
- In the case that the buy-in price is lower than the original transaction price, the corresponding difference “shall be deemed paid”.
- This partially addresses the error in the Level 1 text[17] which outlines the direction of payment in the opposite direction. However, it still creates an unresolvable asymmetry in the event that the buy-in price is lower than the original transaction price.
- Where the failing trading party does not pay the price difference, the failing participant will reimburse the receiving trading party.

---

[16] This is specified in the recitals (36), rather than in the draft RTS

[17] Article 7(6) of the CSDR (Level 1) states: ‘where the price of the shares agreed at the time of the trade is higher than the price paid for the execution of the buy-in, the corresponding difference shall be paid to the receiving participant by the failing participant…’. This is the opposite direction of the normal buy-in process, although it has been suggested that the drafters of the regulation assumed that the bought-in securities would be delivered to the failing party/participant, rather than to the receiving party/participant

- The failing trading party will also be responsible for any related costs (including execution fees). Where the failing trading party does not pay these, the failing participant will reimburse the receiving trading party.[18]
- The same asymmetric treatment of the payment of the differential also applies to cash compensation, with payment being made by the failing trading party only in the case where the cash compensation reference price is higher than the original transaction price.[19]

Cash compensation

- Where the buy-in is not successful and the receiving trading party does not elect to defer the buy-in, or where a deferred buy-in is not successful, the process will default to cash compensation.
- The cash compensation payable is the difference between the market value of the relevant instrument the day before the compensation is due to be paid and the original transaction value (or market value on trade day in case of FoP instructions), as determined by the buy-in agent (for non-cleared transactions) or CCP (for cleared transactions).
- Where the settlement amount is equal or higher than the market value on the day before the compensation is due, cash compensation is null, i.e. it again applies only in one direction (see footnote 2 below).
- The reference price for the cash compensation is determined by:
    - The closing price of the most relevant market in terms of liquidity (where traded on an EU venue), as defined by MiFID II[20]
    - The closing price of the EU trading venue with the highest turnover
    - A pre-determined methodology based on available data.
- The reference value and methodology must be disclosed in detail to the relevant trading parties or clearing members.
- For non-cleared transactions, where the failing trading party does not pay the cash compensation, **the failing participants will not be liable to cover the obligation**.

Contractual arrangements and extraterritoriality

- All parties in the settlement chain shall be bound by appropriate contractual arrangement to enforce the buy-in obligations.
- CSD participants are responsible for ensuring, through their contractual arrangements with clients, that the buy-ins requirements are enforceable in all relevant jurisditctions.

The buy-in agent

- The buy-in agent should have no conflict of interest and should act in the best interest of the failing trading party (or participant).

Exemption for SFTS

- Mandatory buy-ins will not apply to SFTs of fixed terms less than 30 business days. This exemption appears to apply to both the start- and end-legs.
- It is not clear whether this exemption will also apply to open trades.

[18] According to Recital 36 of the draft RTS
[19] This asymmetric treatment is more explicitly provided for in Article 7(7) of the Level 1 regulation
[20] See Article 16 of RTS 22 of MiFID II/R

Non-cleared transactions executed on trading venues

- The buy-in process is executed by the relevant trading venue members (i.e. the trading parties), not the trading venue. Importantly, trading venue members (i.e. the trading parties) are responsible for appointing a buy-in agent, not the trading venue.
- Where there is no direct feed between the trading venue and the CSD, the participant shall identify the trading venue in its settlement instructions.
- Where this information is not available, the transaction shall be treated as OTC.

Mandatory partialing and delivery

- Mandatory partialing should apply on the last day of the extension period, except for the situation where the delivering participant has put instructions on hold.
- The failing party or participant should be able to deliver the relevant instruments to the receiving party or participant up until they are informed that a buy-in agent has been appointed or buy-in auction launched.
- After notification of the buy-in, it is possible for the failing party to deliver the relevant instruments directly to the buy-in agent, or into the buy-in auction, with express consent.