CSDR framework for late settlement penalties

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Background

On March 10 2017, a package of regulatory technical standards (RTS) 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.*

The regulatory initiative is a key component of CSDR's framework for ***Settlement Discipline***, as outlined in Article 7 of the 2014 CSDR, alongside the requirement for CSDs and CCPs to monitor and report participants that consistently systematically fail transactions ('name and shame'), and a mandatory buy-in regime.[1]

The objective of the cash penalties regime is to create a standardized, harmonized penalty regime across the EU to be applied in the event of settlement fails.

Why a penalty regime? (The economics of failing)

In a normal interest rate environment, from the seller's perspective, failing to settle a cash-settled (delivery-versus-payment) transaction comes at a cost. Where the seller is at fault, failing to deliver securities means that they must fund the securities for the duration of the fail, despite not receiving the economic benefits of ownership of the security.[2] Conversely, the failed-to purchaser enjoys an economic gain from being failed to, since they receive the economic benefits of ownership of the security, while not having to fund the security for the duration of the fail. The cost of failing is therefore directly related to the prevailing money market rates: the higher short-term interest rates, the greater the cost of failing. This cost is effectively the same for all cash-settled securities, regardless of security type or asset class.

Since failing to deliver securities against a sale results in a cost to the seller (and a benefit for the purchaser), there is a natural economic incentive to make good on any settlement (whether through operational diligence or utilizing the repo or securities lending markets). However, since the cost of failing is directly related to prevailing funding rates, in a low interest rate environment, the incentive to settle is weakened; to the point where in a zero-rate environment, economically at least, the

[1] The mandatory buy-in regime under CSDR is highly controversial and has been widely and vociferously criticized, particularly by fixed income market participants who point to implementation challenges, as well as to the likely negative implications of a *mandated* regime for bond market functioning and liquidity. The RTS for mandatory buy-ins was not part of the package published on March 10 2017, and at that time these were still waiting approval from the European Commission.
[2] Where the purchaser is at fault for the fail, the failed-to seller can usually make an 'interest claim' against the failing party for the cost of having to fund the securities for the duration of the fail (e.g. Rule 405 of the ICMA Secondary Market Rules & Recommendations).

seller could be indifferent to settlement fails. In a negative interest rate environment, theoretically, the seller could actually profit from failing to settle their trades.[3]

It is in these low-to-negative rate environments, when the natural dis-incentives to failing are diminished, that a 'penalty' regime can potentially replace market forces to ensure that the right economic incentives and disincentives are in place to maintain high levels of settlement efficiency. This was the motivation behind the TMPG (Treasury Market Practices Group) Fails Charge for US Treasuries that was introduced in 2009.

The TMPG Fails Charge is a market led initiative that was introduced in response to the very low rate environment in the US, which seemed to precipitate a decrease in settlement efficiency in the US Treasury market. The mechanism applies an effective 3% (300 basis points) cost to the failing seller for the duration of the fail. In fact, the penalty charge is *3% less the prevailing Fed Funds rate*, which also reflects the natural economic cost of failing. Thus, as market rates move higher, the penalty charge reduces, and with Fed Funds at 3%, the charge becomes zero. Importantly, the charge is paid directly by the failing party to the failed-to party.

Empirical evidence suggests that introduction of the TMPG Fails Charge not only led to an improvement in settlement efficiency rates for US Treasuries, but it also had a positive impact for repo market liquidity, as demand to borrow Treasuries, even at relatively expensive levels, increased.

The CSDR penalty framework

The CSDR penalty mechanism works on a similar principle, however it is administered at the CSD level, with EU (I)CSDs penalizing failing participants and then passing this on to the failed-to participant. The charges themselves are flat, ad valorem fees (expressed as a % of the market value of the relevant security), rather than a money-market equivalent rate, and are independent of prevailing money-market rates or any benchmark rate. The charges are applied on a daily basis (per business day, rather than calendar day), and there are different charges depending on security type/asset class, and (in the case of shares) liquidity (as determined by MiFID II).

The penalty rates to be charged are outlined below, along with the approximate 'repo rate equivalent cost'.

Type of fail/security	Penalty Rate	Equivalent repo rate 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%)

[3] In 2015, ICMA introduced Rule 407 to its SMR&Rs to allow the failed-to purchaser to make interest claims against the failing seller in such circumstance, to ensure that the 'positive' incentive to failing was removed.

To ensure consistency in the charges being made (and credited) by various CSDs, single reference prices will be used for each individual security, for each day, when calculating the penalty. The regulation provides that 'the establishment of reference prices should be based on objective and reliable data and methodologies'. In the case of instruments admitted to trading on a trading venue within the EU, this will be the closing price of the most relevant market in terms of liquidity, or the closing price on the venue with the highest turnover. For other financial instruments, the value is to be determined on the basis of a predetermined methodology approved by the competent authority of the relevant CSD.

In determining the appropriate penalty rates, ESMA considered a balance between an effective deterrent to failing and minimizing negative impacts on the orderly and smooth functioning of markets. In doing so, they attempted to take into account the liquidity and transaction sizes of different instruments, as well as the typical repo or securities lending rates for those markets.

Timeline for implementation and operational considerations

The regulation enters into force on the twentieth day after publication in the Official Journal, but a two-year delay to application is provided to allow CSDs sufficient time to undertake the extensive technology builds required to support the implementation of the regime. Furthermore, it is intended to be implemented at the same time as the other elements of Article 7, including mandatory buy-ins, which means that the earliest the penalty regime will be applied is **June 2019**.

In this context, it is also worth noting that Target2-Securities (T2S) has established a CSDR Task Force, which is assessing ways to develop a centralized solution for cash penalties in T2S. However, firms will still be required to build their own internal processes to manage the penalty mechanism: firstly, to reconcile the net payments and charges from the respective CSDs (likely to be made on a monthly basis) and, secondly, to attribute these, at a gross level, to the respective failing transactions and the underlying trading books or profit centres.

Potential impacts for the fixed income market

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 has been that the penalty rates, with respect to fixed income, are too low to make any meaningful impact on settlement efficiency (citing the 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 need 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) or to reduced liquidity in the repo and securities lending markets.

From an overall market liquidity perspective, the very low penalty charges are again unlikely to make much impact, and pale into insignificance when compared to the expected market impacts of the parallel mandatory buy-in regime. A common recommendation from ICMA's membership is that a more dynamic and appropriately calibrated penalty regime would be far more effective in terms of supporting settlement efficiency, while negating the need for a *mandatory* buy-in regime and the negative consequences of that for bond market liquidity.

Prepared by Andy Hill, March 2017

andy.hill@icmagroup.org