International Capital Market Association

Mandatory buy-ins under CSDR and the European bond markets

Impact Study

An initiative of the ICMA Secondary Market Practices Committee

November 2019

Disclaimer

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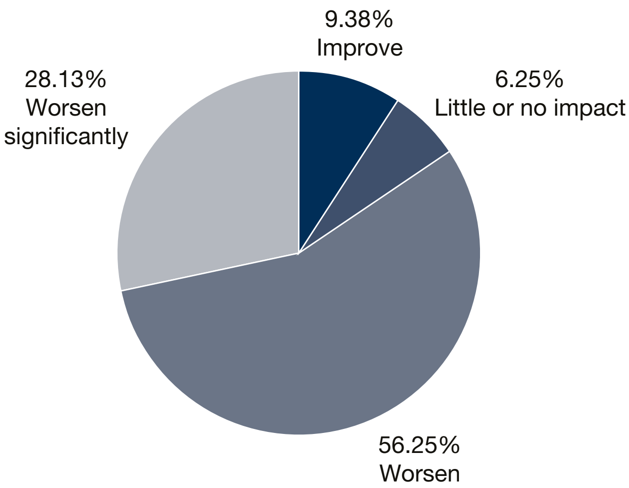
Contents

Executive summary

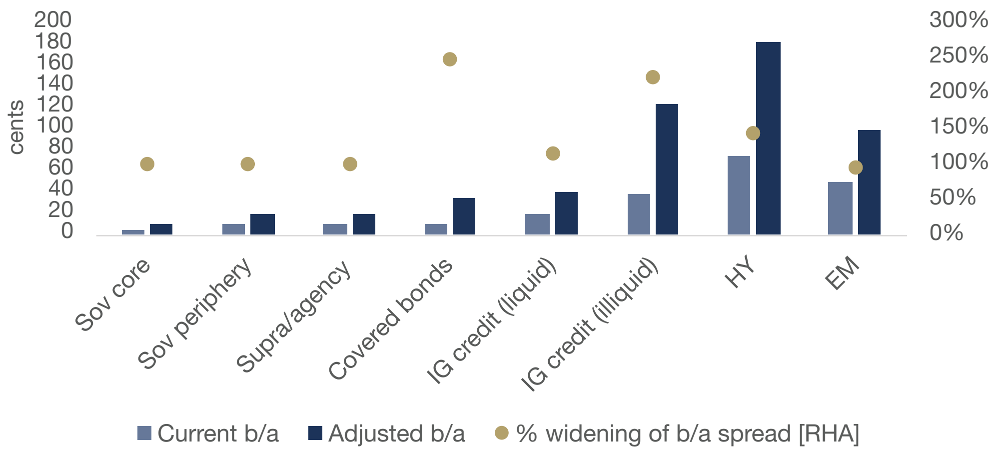
- The survey-based study is a follow-up to ICMA's 2015 impact study and is intended to assess the impact of the CSDR mandatory buy-in regime on the European bond secondary markets (due to go live in September 2020, but expected to be extended to November 2020 due to a technical issue related to CSDR cash penalties).
- The study sets out to answer five key questions: (i) What is the general preparedness of firms both from an operational and trading strategy perspective? (ii) How will sell-sides adjust their pricing and liquidity provision across a range of bond sub-classes? (iii) What are the expectations of buy-sides with respect to pricing and market liquidity? (iv) What are the likely impacts for repo and securities lending? (v) What possible refinements or enhancement to the framework could help to mitigate the risks of unintended consequences?
- In total, there were 44 responses to the survey, representing buy-side firms (16), sell-side firms (16), and repo and securities lending desks (12).

Expected impact of mandatory buy-in regime on market efficiency and liquidity



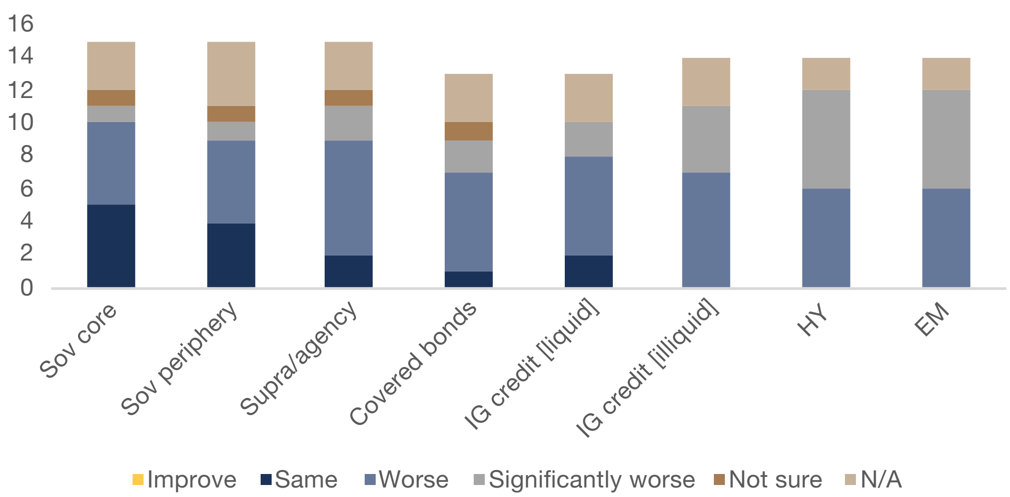
- Overall, the mandatory buy-in regime is expected to have significant negative impacts for bond market liquidity and efficiency.
- More than half of respondent firms have plans to adapt their operational processes as well as their approaches to trading and risk management, with repo and securities lending businesses leading the field. However, the general view across all constituents is that there is limited or little market awareness of the regulatory requirements and likely impacts.
- In terms of price impacts of the regulation, bid-ask spreads of all bond sub-classes are expected to more than double, with covered bonds and illiquid IG credit seeing the biggest impact. In absolute price terms, the impact is most notable at the lower end of the credit spectrum, with significant increases for emerging market, high yield, and illiquid IG corporate bonds.

Impact of mandatory buy-in regime on bid-ask spreads



- The new buy-in regime is expected to impact the capacity of market-makers to show offers across all bond sub-classes, with core sovereign markets the least affected. Again, it is the lower end of the credit spectrum that is most impacted, in particular illiquid IG credit and high yield.
- Buy-side expectations for the impact on pricing are largely consistent with the indications of price adjustment from sell-sides. While they expect a general worsening of offer-side pricing across all sub-classes, there is a realization that the biggest impact will be at the lower end of the credit spectrum.
- The survey responses suggest that for the most part, lending and repo activity will continue as normal for SSAs. For other sub-classes of bonds, however, the indication is that borrowing securities will become both more expensive and more difficult.

Expected impact on offer-side pricing



- There is little expectation among respondents that the regulation will improve investor protection.
- The cost of widening bid-ask spreads and diminished market liquidity will be directly borne by buy-side, including UCITS, insurance companies, and pension funds.
- Furthermore, reduced secondary market liquidity will likely have an indirect impact on the cost of issuance and even access to the capital markets for certain issuers, not least smaller corporates and emerging sovereigns.
- The anticipated market impacts of the EU's mandatory buy-in regime suggest that the real economic consequences are likely to be profound, while the benefits remain unclear.
- In terms of recalibrations to the regulation to lessen the negative impacts, introducing a longer extension period (with a suggestion of 30 business days) is broadly viewed as being a helpful initiative. However, removing the mandatory requirement (if only for illiquid bonds) is overwhelmingly seen as being the most constructive modification.

Background

In 2015, mainly in response to concerns raised by sell-side members, ICMA undertook an Impact Study of the projected CSDR mandatory buy-in provisions on European bond markets.[1] A controversial piece of market regulation buried in legislation focused on settlement systems, the CSDR buy-in framework is a radical reinterpretation of how contractual buy-ins work in the non-cleared securities markets: legally, structurally, and potentially economically. Most significantly, the regulatory provisions would increase the market risk of liquidity providers considerably.

The approach to the 2015 study was to survey sell-side fixed income trading desks on the expected changes they would need to make to their offer-side liquidity provision as a consequence of mandatory buy-ins, across a broad range of asset sub-classes. The survey results from 17 firms[2] that are active market-makers in the European fixed income markets were aggregated and anonymized.

The study suggested that if, or when, mandatory buy-in regulation is implemented (then scheduled for early 2016), liquidity across secondary European bond and financing markets would reduce significantly, while bid-offer spreads would widen dramatically. The results implied that even the most liquid sovereign bonds would see bid-offer spreads double, while secondary markets in less liquid corporate bonds could effectively close. The survey further suggested that for many less-liquid bonds, including sovereign and public issues, market-makers would retrench from providing liquidity altogether.

Following a consultation and reworking of the regulatory technical standards (RTS) for the buy-in framework, the RTS were published by ESMA in February 2016. After a two-year delay (largely encouraged by industry representatives such as ICMA), the RTS were finally accepted by co-legislators and published in the European Commission's Official Journal in September 2018.[3] The mandatory buy-in framework is due to come into force from September 2020 (although this is now expected to be November 2020).

Since the publication of the RTS in 2018, ICMA has been focused on implementation challenges and updating its own Buy-in and Sell-out Rules[4] to provide a contractual framework and market best practice to support members' compliance with the regulatory requirements. However, in the past twelve months, concern among ICMA's members, in particular buy-sides, has increased as the prospect of the mandatory buy-in regime looms. This became very evident in the undertaking of ICMA's third study into the state and evolution of the European investment grade corporate bond market[5] (see chart below). It therefore felt timely to revisit the potential impacts that the mandatory buy-in regime could have on the liquidity, pricing, and resilience of the European bond and repo markets.

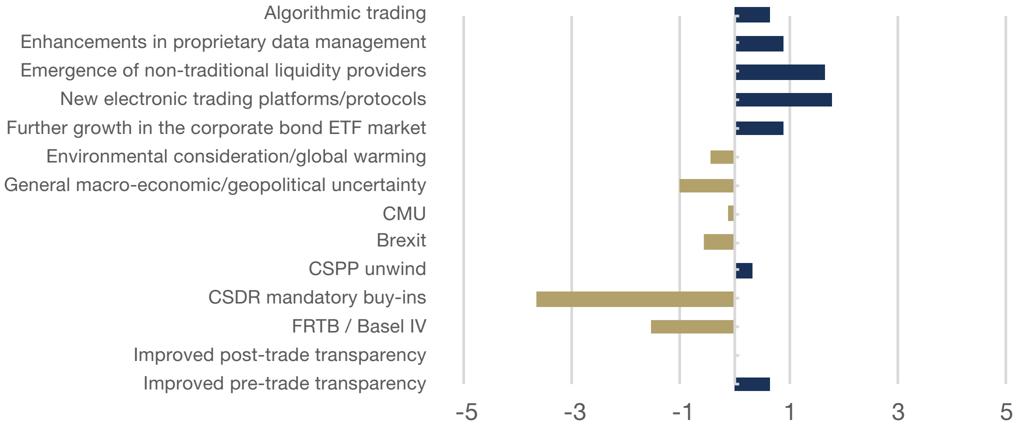
In September 2019, ICMA launched a second impact study. Similar to the previous study, this set out to ascertain the potential impacts on liquidity and pricing across a range of fixed income sub-classes. This time, the surveys also focused on three main constituencies: sell-side market-makers, buy-sides, and repo and securities lending desks. It also sought to establish market preparedness and expectations, as well as assessing potential modifications intended to lessen the undesirable consequences of the buy-in framework.

1 ICMA Impact Study for CSDR Mandatory Buy-ins (2015)
2 A total of 19 firms participated, including survey responses on repo liquidity provision
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
4 The ICMA Buy-in Rules are part of the ICMA Secondary Market Rules & Recommendations, which apply automatically to ICMA members transacting in international securities.
5 Due for publication early 2020

Factors expected to impact corporate bond market liquidity in the next three years [buy-side]

-5 is very negative, +5 is very positive, and 0 is neutral

Impacts on liquidity



Source: ICMA survey (3rd European IG corporate bond secondary market study) [survey data 2019]

Scope and methodology of the study

The study sets out to answer five key questions:

- What is the general preparedness of firms both from an operational and trading strategy perspective?
- How will sell-sides adjust their pricing and liquidity provision across a range of bond sub-classes?
- What are the expectations of buy-sides with respect to pricing and market liquidity?
- What are the likely impacts for repo and securities lending?
- What possible refinements or enhancement to the framework could help to mitigate the risks of unintended consequences?

Online surveys were developed, targeted at three different member constituencies:

- Sell-side market-makers
- Buy-side investors and asset managers
- Repo and securities lending desks

In terms of bond sub-classes, these were divided into the following buckets:

- Sovereign (core)
- Sovereign (periphery)
- Supranational/agency
- Covered bonds
- IG credit (liquid)
- IG credit (illiquid)
- High Yield
- Emerging Market

Responses

In terms of survey contributions, the surveys received a total of 44 responses. Not all respondents answered every question, and the range of responses for each of the three surveys are spread accordingly: *sell-side (6-16); buy-side (15-16); repo/securities lending (11-12).*

Participating firms were assured of anonymity, but respondents represent a broad range of investment firms active in the European bond markets, including some of the largest global investment banks and asset managers.

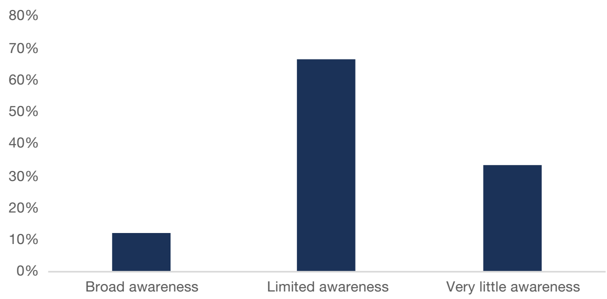
Survey results

I. Awareness and preparedness

Q. Do you think there is broad market awareness of the requirements and likely impacts of the regulation?

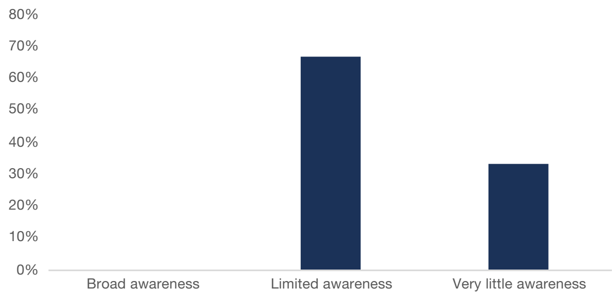
Combined

Market awareness



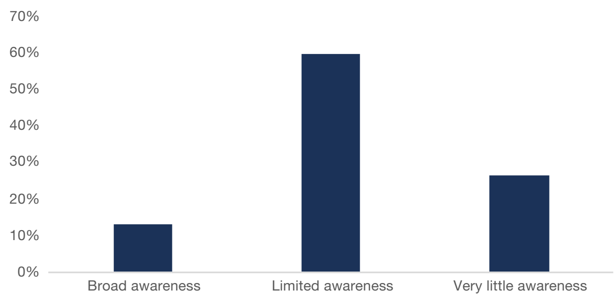
Sell-side

Market awareness



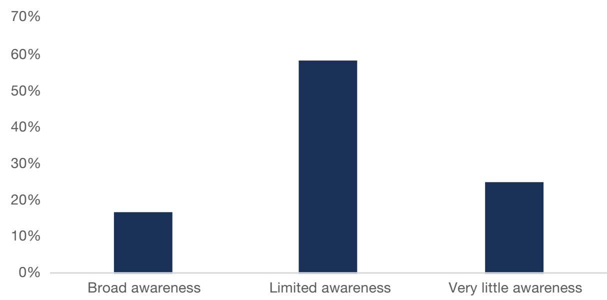
Buy-side

Market awareness



Repo and securities lending

Market awareness

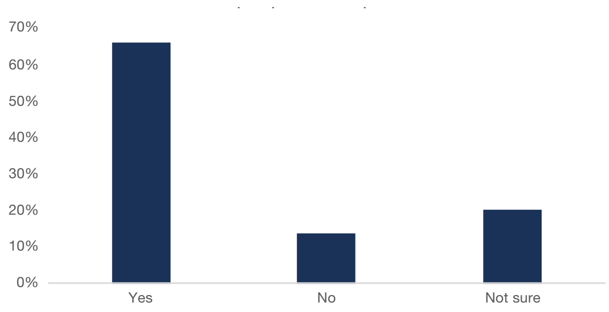


The general view across all constituents is that there is limited or little awareness of the regulatory requirements and likely impacts.

Q. Is your firm already in the process of making plans to adapt its business and processes as a result of the CSDR mandatory buy-in regime with respect to operational processes?

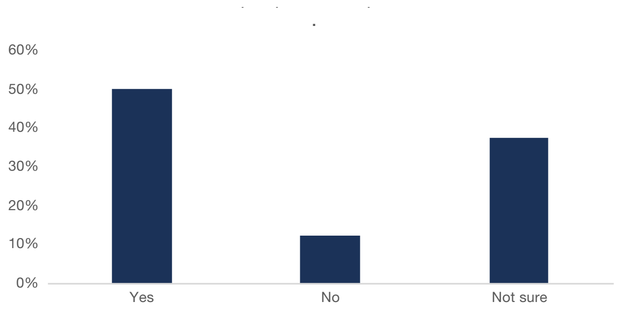
Combined

Plans to adapt operational processes



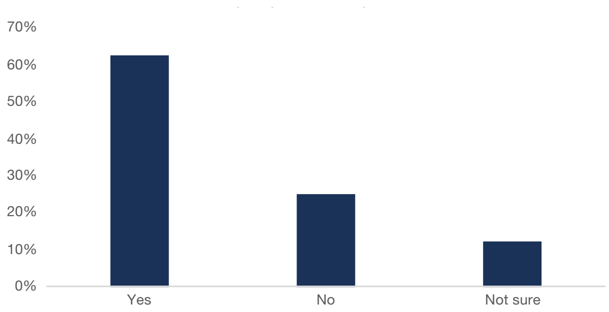
Sell-side

Plans to adapt operational processes



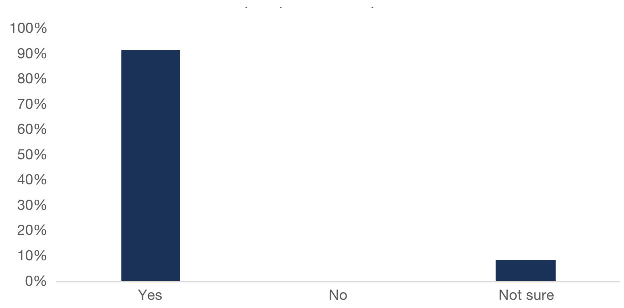
Buy-side

Plans to adapt operational processes



Repo and securities lending

Plans to adapt operational processes

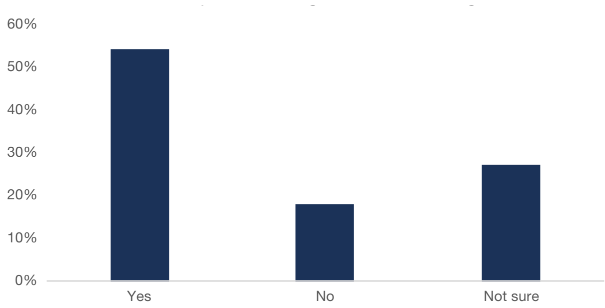


More than half of respondent firms have plans to adapt their operational processes, with repo and securities lending businesses leading the field (91% already in the process of adaptation). Interestingly, buy-sides appear to be ahead of sell-sides in adapting their processes (62% vs 50%).

Q. Is your firm already in the process of making plans to adapt its business and processes as a result of the CSDR mandatory buy-in regime with respect to risk management and trading flow?

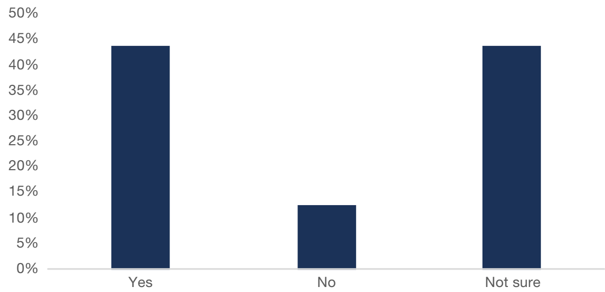
Combined

Plans to adapt risk management and trading



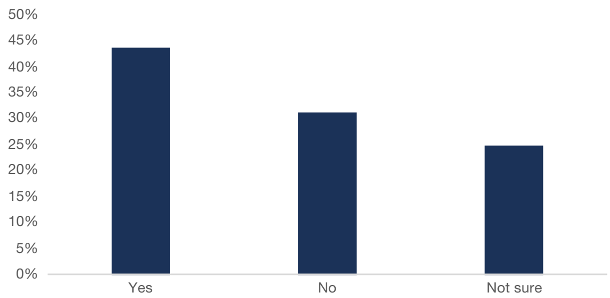
Sell-side

Plans to adapt risk management and trading



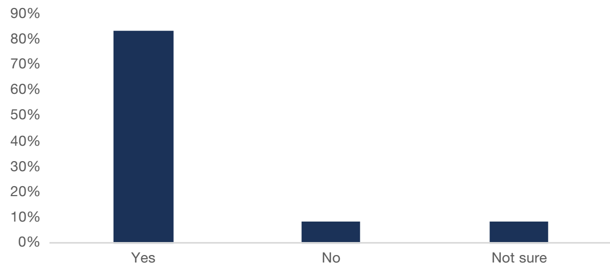
Buy-side

Plans to adapt risk management and trading



Repo and securities lending

Plans to adapt risk management and trading

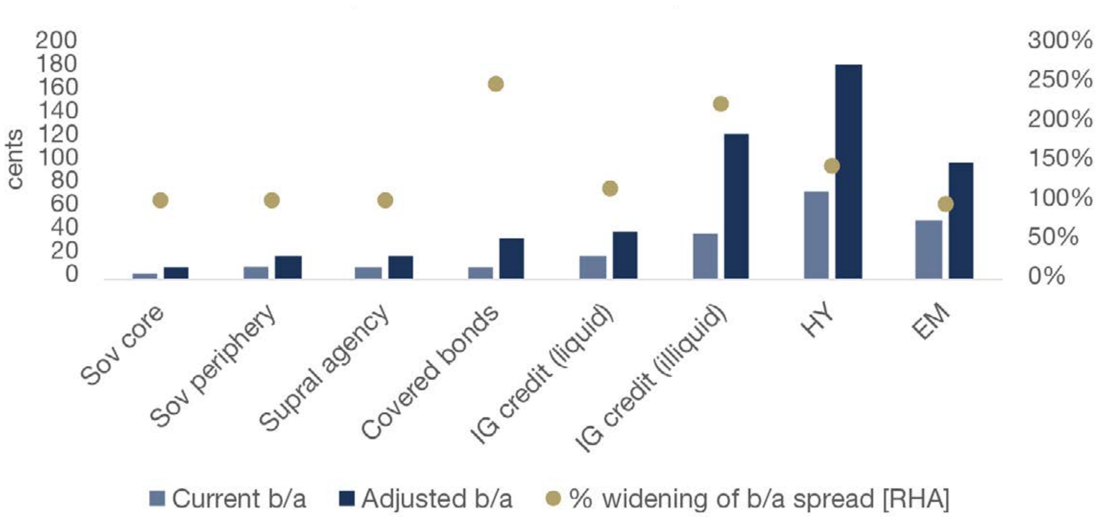


In terms of adapting risk management and trading strategies, repo and securities lending desks seem to be more advanced (with 83% already preparing). Less than half of buy-sides and sell-sides confirm that they are adapting their businesses (44% each), although there is a high degree of uncertainty.

II. Sell-side pricing and liquidity

Market-makers were asked to provide their current average bid-ask spread, in cents, based on a 5-year maturity bond across a range of bond sub-classes. Current bid-ask spreads reflect very low probability of being bought-in. They were then asked to provide the average offer-side adjustment they would expect to make for bonds that they did not hold in inventory following the introduction of mandatory buy-ins.[6] This adjustment reflects the increased buy-in risk resulting from the mandatory buy-in provisions.

Impact on bid-ask spreads



While this question drew the least number of responses (with some firms not wishing to disclose information on their pricing policies), responses were relatively consistent across sub-classes, and are largely in line with the (less granular) results of the 2015 study.

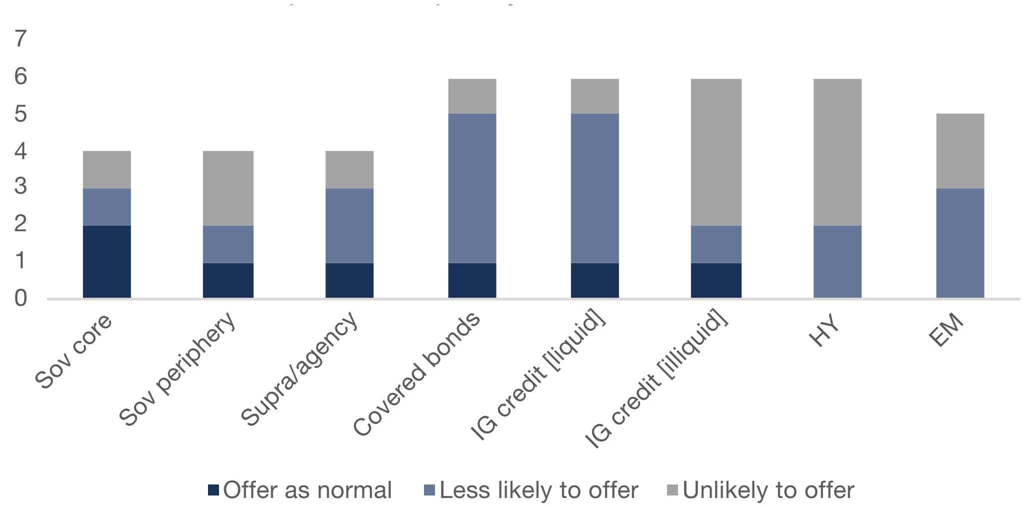
In terms of relative widening of bid-ask spreads, all sub-classes (including core sovereigns) experience at least a doubling, with covered bonds and illiquid IG credit seeing the biggest impact (a widening of 250% and 225% respectively). In absolute terms, the impact is most notable at the lower end of the credit spectrum, with significant increases in offer side pricing for emerging market, high yield, and illiquid IG credit bonds.

"…the impact is most notable at the end of the credit spectrum."

6 It is important to appreciate that following post-crisis regulatory reforms, the balance sheet available to market-makers has shrunk significantly, and with this the capacity to hold inventory on their trading books. This means that the ability and willingness to short securities has become an ever more important requisite for servicing clients and providing offer-side liquidity.

Q. How do you expect the regulation to affect your capacity to show offers in various bond sub-classes not held in inventory?

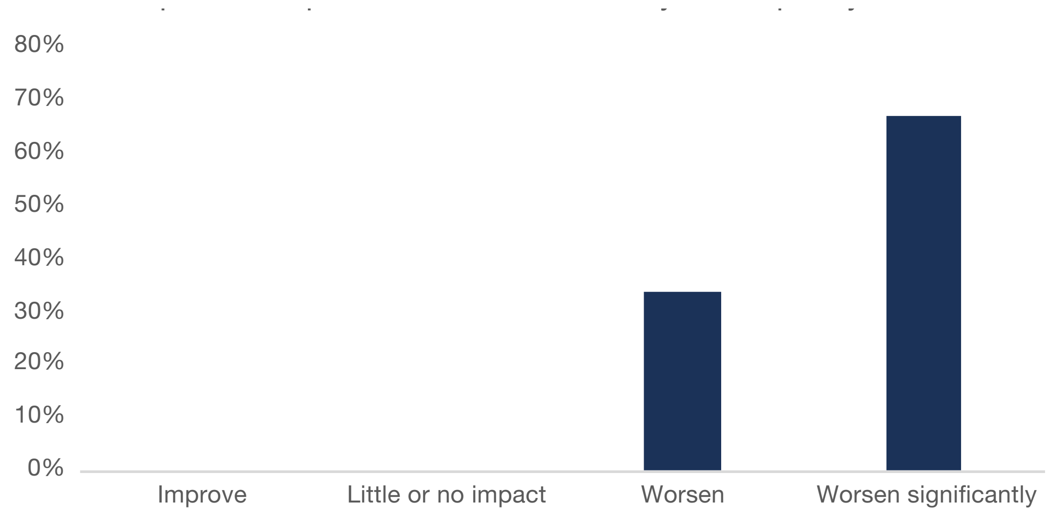
Expected capacity to show offers



Again, the regulation appears to impact the capacity of market-makers to show offers across all asset classes, with core sovereign markets the least affected. Meanwhile, it is the lower end of the credit spectrum that is most impacted, in particular illiquid IG credit and high yield.

Q. How do you think the regulation will impact overall bond market efficiency and liquidity?

Expected impact on market efficiency and liquidity

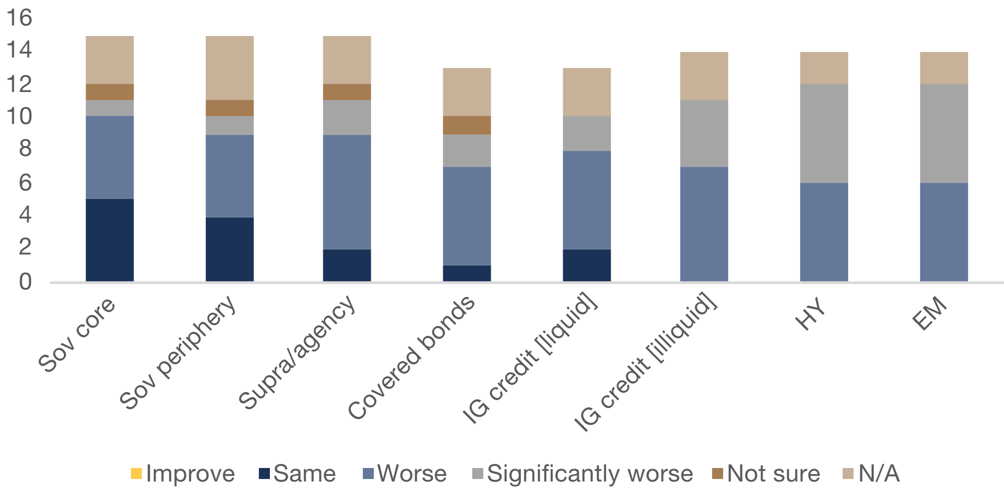


The overwhelming view of sell-sides is that mandatory buy-ins will be bad for bond market efficiency and liquidity. The only division of opinion is as to how bad.

III. Buy-side expectations

Q. How do you expect the regulation to impact offer-side pricing for various bond sub-classes?

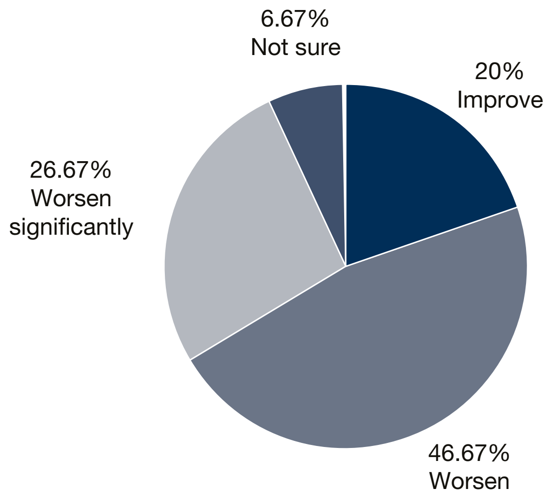
Expected impact on offer-side pricing



Buy-side expectations for the impact on pricing are largely consistent with the indications of price adjustment from sell-sides. While they expect a general worsening of offer-side pricing across all sub-classes, there is a realization that the biggest impact will be at the lower end of the credit spectrum. Comparing the sell-side and buy-side responses, it may be that buy-sides have not fully anticipated the extent of the impact with respect to covered bonds.

Q. How do you think the regulation will impact overall bond market efficiency?

Expected impact on market efficiency and liquidity

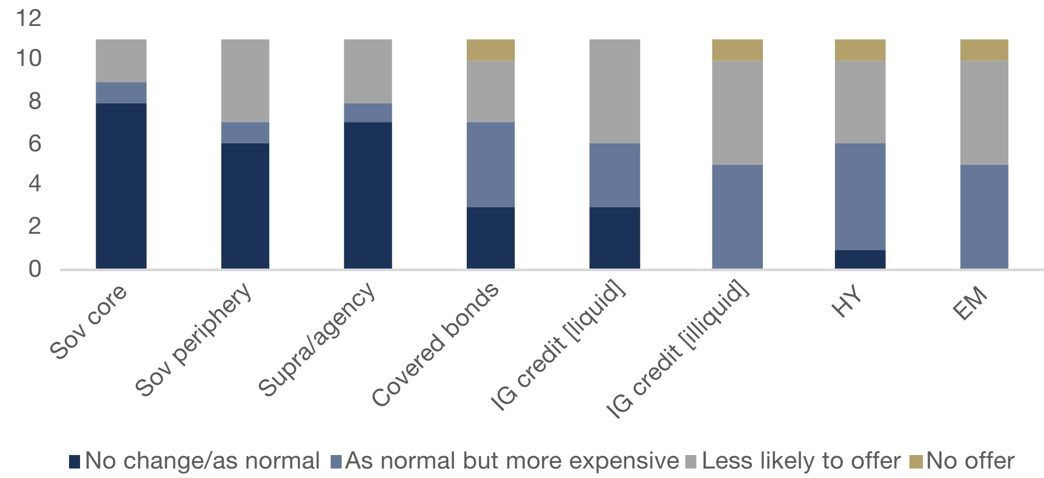


While 75% of buy-side respondents expect mandatory buy-ins to have a negative impact on overall bond market efficiency and liquidity, 20% suggest that it may have a positive impact.

IV. Repo and securities lending

Q. How do you expect the regulation to impact your capacity/willingness to lend various bond sub-classes?

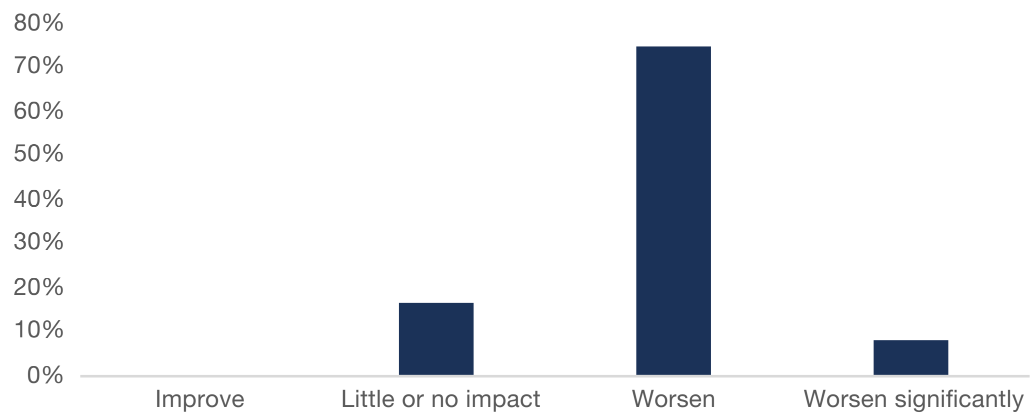
Expected impact on lending securities



The survey responses suggest that for the most part, lending and repo activity will continue as normal for sovereigns, supranationals, and agencies (SSA). For other sub-classes of bonds, however, the indication is that borrowing securities will become both more expensive and more difficult.

Q. How do you think the regulation will impact overall SFT market efficiency and liquidity?

Expected impact on SFT market efficiency and liquidity

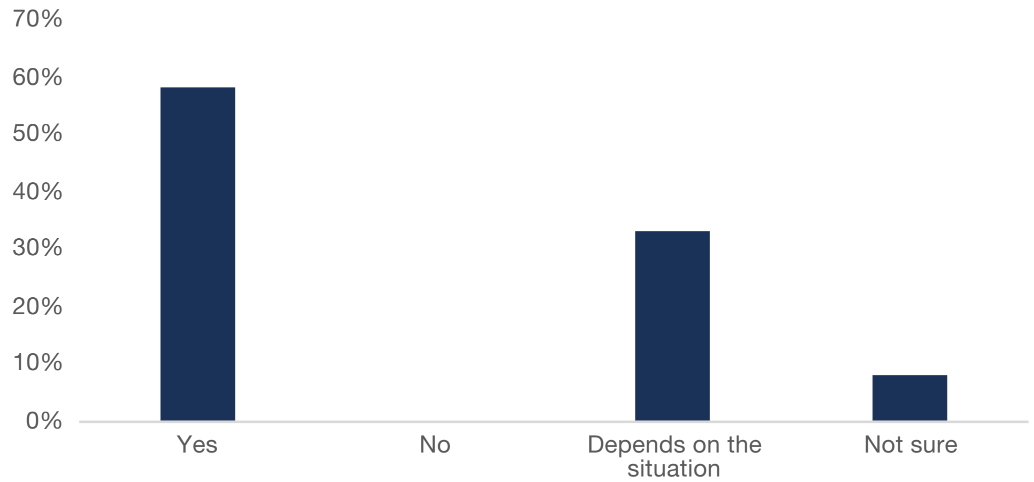


83% of respondents feel that mandatory buy-ins will have a negative impact on overall SFT market efficiency and liquidity, while 17% expect little or no impact.

"...the indication is that borrowing securities will become both more expensive and difficult"

Q. For in-scope SFTs, do you agree with the suggested market best practice of relying on the relevant contractual provisions for fails before the end of the extension period rather than going to a mandatory buy-in?

Use of Master Agreement provisions



Buying-in an SFT is not straight forward (effectively it is replacing a short-term loan of securities with an outright purchase). It has therefore been suggested that market best practice with respect to in-scope SFTs should be to use the provisions for fails in the relevant contractual master agreements before the end of the extension period, so avoiding a buy-in situation.

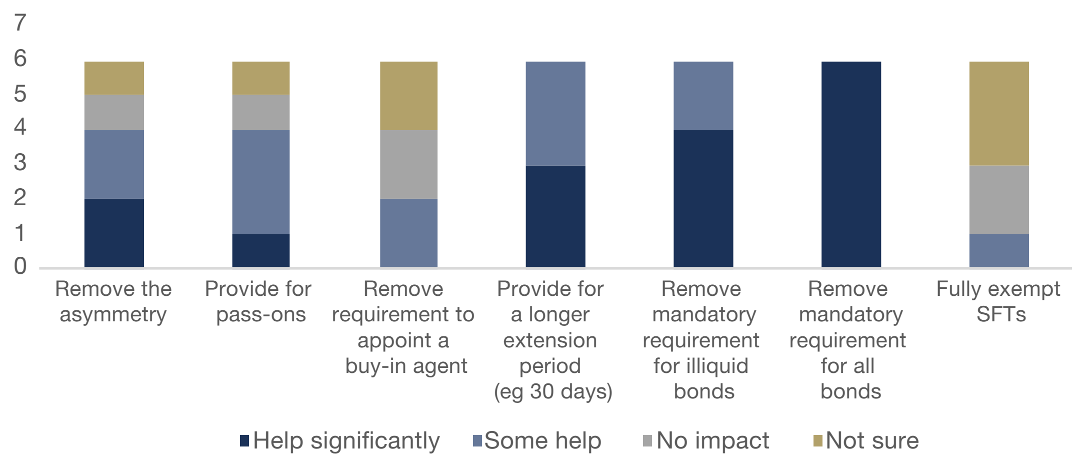
While 58% of respondents seem to support this suggestion, a third (33%) seem to prefer the idea of being able to choose between the two options depending on the circumstances.

V. Possible enhancements to the CSDR buy-in framework

Q. Which of the following enhancements to the regulation do you think would help to mitigate some of the negative impacts on market pricing and liquidity?

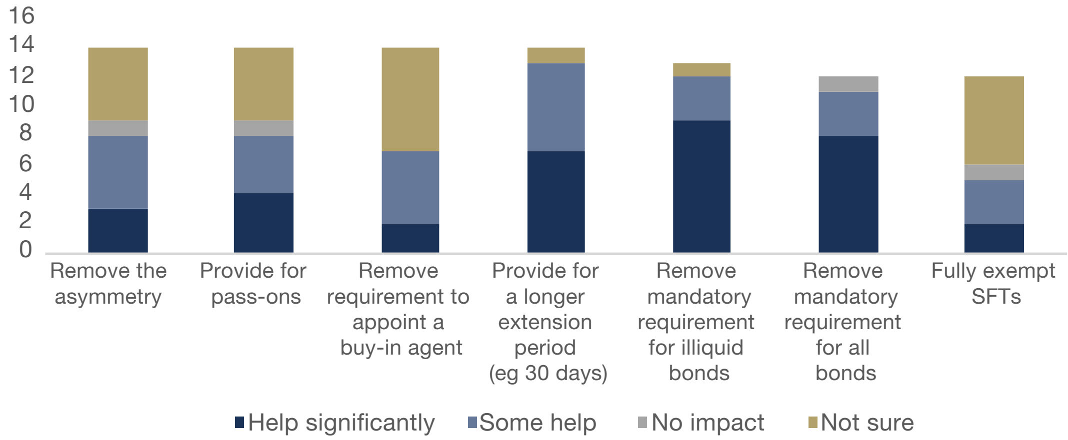
Sell-side

Assessment of possible enhancements to the regulation



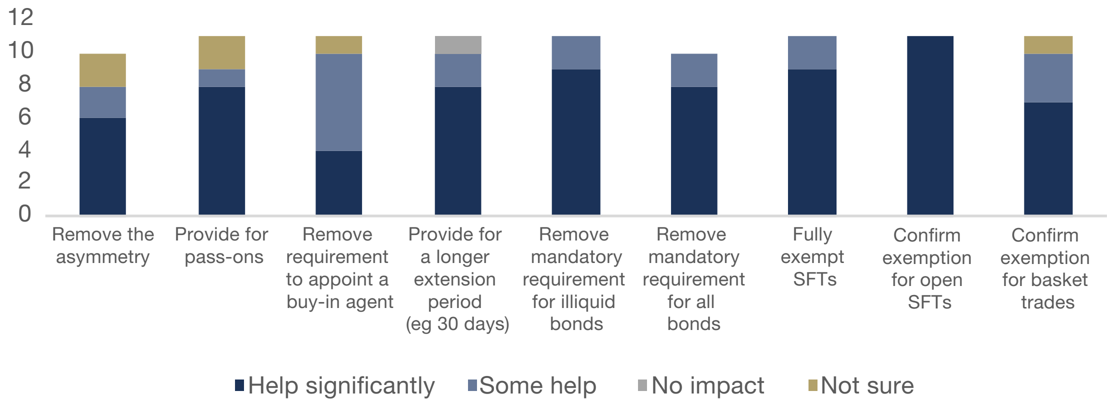
Buy-side

Assessment of possible enhancements to the regulation



Repo and collateral

Assessment of possible enhancements to the regulation



While currently there is industry work being undertaken to find a contractual solution for the differential payment asymmetry as well as to establish a pass-on mechanism, both of which may be possible within the provisions of the regulation, sell-side and buy-side respondents generally see these enhancements as only helping to an extent (although repo and securities lending constituents attribute more relevance to these initiatives). Removing the requirement to appoint a buy-in agent is also seen as helping, although there is also a fair degree of uncertainty among respondents.

Introducing a longer extension period (with a suggestion of 30 business days) is broadly viewed as being a more helpful initiative, however, removing the mandatory requirement, if only for illiquid bonds, is overwhelmingly seen as being the most constructive modification.

From an SFT market perspective, confirming that open trades are out of scope will be a significant plus, while fully exempting SFTs would also be helpful.

Comments

Participants were also asked to provide additional comments, which are summarized below:

Buy-side

- Corporate bond markets rely heavily on liquidity providers shorting bonds that they do not own. This has always been the case. Liquidity is already very challenging and getting even more so. This regulation, in its current form, is likely to mean that banks will not short bonds. This would have a devastating impact on market liquidity, function and Asset Managers ability to service their clients effectively. It is worrying that many in a front office, markets facing position know nothing or very little about this impending regulation.
- The survey misses that not only EUR denominated assets are affected by these changes. The entire USD/GBP credit space is also in scope for transactions that settle in Euroclear/Clearstream, as well as all the EU local markets (Poland, Czech etc.).
- The asymmetry creates an effective put option for the buyer and theoretical unlimited downside for the seller. This will disincentivize market makers from offering bonds until trades in their book are settled. Hedge funds may also try to exploit this regime.
- There are likely to be disputes on the mandatory buy-in / cash compensation price: what will be the process for handling these?
- There is likely to be differential pricing between quotes depending on where trades are settling (DTCC vs Euroclear/Clearstream).
- There will be issues for index replicability [e.g. for ETFs]. The free float in some corporate securities will not be enough for size of AUM tracking.
- There will be general concerns over market makers' ability to manage their balance sheets freely.
- This will significantly reduce a bank's willingness to offer bonds short in Emerging Markets and High yield. This will reduce liquidity significantly.

Sell-side

- This regulation will severely impact the market. We fear illiquid and HY parts of the market will become even less liquid or certain parts cease to trade. There will no choice but to widen pricing in the HY and illiquid spaces to the detriment of investors.
- The regulation will destroy the market forcing much more volatile conditions and long-only trading desks.

Repo and securities lending

- Start leg of OPEN repos should be exempt. Start legs of term repos most likely should be exempt as well. However, end legs of repos need to be considered in this rule. If a counterparty fails to deliver back bonds that are part of an end leg repo this can impact the cash market and the bond liquidity. We will need the ability to pass on buy-ins coming from cash fails or other end leg of repos.

Conclusion

The survey results clearly support the broad market view that the CSDR mandatory buy-in regime is likely to have a significant impact on European bond market pricing and liquidity across all bond sub-classes, but most acutely at the less liquid end of the credit spectrum. There is also a wide perception of a general lack of awareness of the regulatory requirements and likely impacts across the market.

While many respondent firms are beginning to adapt both their operational processes and trading and risk management approaches, there are still a number of uncertainties that would benefit from clarification, such as the ability to resolve the payment asymmetry, the possibility of a pass-on mechanism, and the scope of application to SFTs.

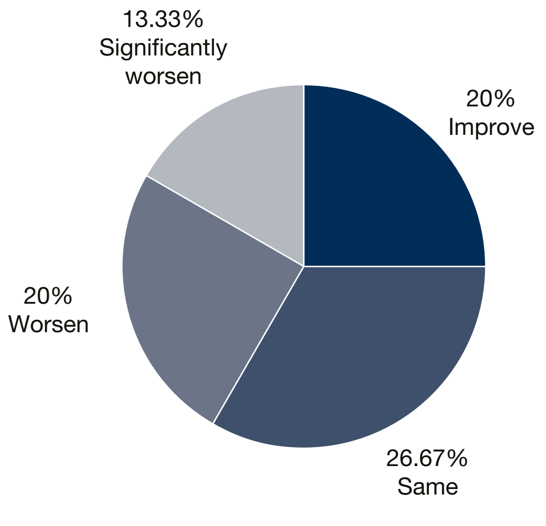
However, what the study highlights quite clearly is that to avoid the potentially significant negative impacts on bond market liquidity and pricing, the regulators should consider more intrinsic modifications to the regulation, such as applying a much longer extension period, or exempting less liquid (or all) bond asset classes.

Finally, if the intention of the CSDR mandatory buy-in regime is to improve investor protection, there is little confidence among respondents that it will achieve this objective.

Q. How do you think the regulation will impact overall investor protection?

Combined

Expected impact on investor protection



As highlighted by the 2015 impact study (which also attempts to assign an annual cost of the regulation),[7] the cost of widening bid-ask spreads and diminished market liquidity are directly borne by buy-side and the end investors on whose behalf they act. These include UCITS, insurance companies, and pension funds. Furthermore, reduced secondary market liquidity will likely have an indirect impact on the cost of issuance, and even access to the capital markets, for certain issuers, not least smaller corporates and emerging sovereigns. If the estimated impacts outlined in this study are correct, the real economic consequences of the EU's mandatory buy-in regime are likely to be profound, while the benefits remain unclear.

7 Based on reported European bond market turnover and the then predicted widening of bid ask spreads, the cost of the regulation borne by investors was conservatively estimated to be in the region of €35 billion per annum.

Context: CSDR and mandatory buy-ins

CSDR

CSD Regulation (CSDR) is an EU regulation that was passed into law in 2014.[8] CSDR introduces measures for the authorization and regulation of EU central securities depositories (CSDs), and while much of the regulation focuses on the prudential, organizational, and business standards of CSDs, some of its requirements directly affect trading level entities that settle trades on EU CSDs and ICSDs. These include measures to address settlement fails. Chapter III of the Regulation deals with Settlement Discipline. Article 7 provides for measures to address settlement fails, including cash penalties for settlement fails and mandatory buy-ins.

Buy-ins

Buy-in mechanisms are nothing new in securities markets and are widely used as a contractual means to force delivery of securities in the case of a settlement fail. Exchanges and central counterparty clearing houses (CCPs) generally have rules that allow them to action a buy-in in the event that a member fails to settle a security. In the non-cleared markets, contractual arrangements between trading entities will allow the non-failing purchasing party to issue a buy-in against its failing selling counterparty.[9] For instance, in the non-cleared cross-border bond markets, the ICMA Buy-in Rules are widely relied upon.

In a buy-in, the non-failing party attempts to source the failing securities, usually for guaranteed delivery,[10] from another entity. Depending on the contractual framework being used, this could be via an independent third-party (a 'buy-in agent') or they could source the securities directly.[11] Once they have successfully sourced the securities, the original delivery of securities from the failing selling party is cancelled, and any difference in the economics between the original transaction and the buy-in are settled between the two original parties. In this way, both parties are restored to the economic position they would have been in had the original trade settled.

The economics of a buy-in

While buy-ins are a restorative remedy designed to force delivery and make parties to the transaction whole, they are often expensive for the failing party being bought-in. This is because the price at which a buy-in executed is generally higher than the prevailing market price at the time of the buy-in. This could be due to additional costs being built into the price by a buy-in agent, but it is mainly due to the additional premium that is charged by the seller for guaranteed delivery. Following a buy-in, the sale of the failing selling party is cancelled, thus leaving them with a long position (or a flat position in the case of a short-sale). This will require them either to re-sell the securities, to reestablish the same risk position, or to mark their new position to market.[12] In either instance, any difference between the buy-in price and the current market price will produce a trading loss.[13] In the case of very illiquid or difficult to source securities, the buy-in premium can be significant.

Pass-ons

An important feature of any buy-in framework is a pass-on mechanism. This allows parties who have matching failing trades (a purchase and sale) in the same securities, to pass-on any buy-in they receive against their failing sale directly to the counterparty for their failing purchase. Often, event or price driven activity in a security can lead to transaction chains involving multiple parties with matching sales and purchases. In the event of a settlement fail, this can cause an entire transaction chain to fail. A pass-on mechanism facilitates a scenario whereby one buy-in (usually the final purchasing party in the chain) can settle the entire chain, so avoiding multiple buy-ins (which would create additional and unnecessary risks for the parties in a chain and could also be market destabilizing). In the same way as a bilateral buy-in, all deliveries through the chain are cancelled, and the differences between the value of the buy-in and that of the various transactions in the chain are settled between the counterparties throughout the chain. In this

8 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 and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012

9 Sell-outs are the mirror mechanism, which can be used by non-failing selling parties against failing purchasing parties.

10 Guaranteed delivery is generally taken to mean that the selling or delivering party is certain that they can settle the trade. This is generally because they hold the securities in their account, and these have not been used for any other purpose, such as securing a repo or securities lending transaction.

11 This has been the case with the ICMA Buy-in Rules since 2017.

12 The economic and risk equivalent of being bought-in is a new long position (at the buy-in price). Thus, parties being bought in will have either to run this new position or re-sell it to restore their original position.

13 It is a common mistake to assume that any losses incurred by the party being bought-in are a result of the difference between the original transaction price and the buy-in price. This is not the case, since that difference is settled between the trading parties to ensure that they are made whole. For example, in the case that the buy-in price is lower than the original trade price, the difference is paid from the non-failing purchaser to the failing seller.

way, everybody in the chain is restored to the economic position they would have been in, with the final purchasing party receiving their securities, and any costs (i.e. the buy-in premia) being borne by the original failing selling party.

Using buy-ins

Despite being an important risk management tool for trading parties, buy-ins are seldom used in the non-cleared bond markets. While there is very little data available on settlement fails on EU CSDs and ICSDs, empirical and anecdotal evidence suggest that settlement fails are relatively rare and tend to clear up within a few days. Particularly in less liquid markets, investment firms also tend to be more tolerant of settlement fails. It is understood that when purchasing illiquid securities, there is a possibility that the settlement could fail for a period of time, particularly where the purchase is from a market-maker who may not hold the securities in inventory. It may take time for liquidity providers to cover their sales, whether by buying the securities or borrowing them in the repo market. Also, it is not guaranteed that the market-maker's covering trade will settle. Investors will establish a balance between sourcing the liquidity they require in certain markets or underlying securities and a degree of tolerance for the possibility of late settlement. Meanwhile, if market-makers feel that they will not automatically be bought-in in the event of a settlement fail, this will provide them with the confidence to show offers in securities that they do not hold on their trading books.

It is also important to remember that buyers of securities are not economically disadvantaged by a failing settlement, since legally they still own the securities they have purchased, along with all the economic benefits and cash flows of that ownership. Furthermore, given that trades are usually settled on a delivery-versus-payment basis, the purchaser will still hold the cash (as well as owning the securities) and have use of this while the trade remains unsettled. So long as they are happy with the credit risk of their failing counterparty, this could be the difference between successfully executing an order and not.

CSDR buy-ins

The provisions for CSDR buy-ins are laid out in the regulatory technical standards, which were published in the European Commission's Official Journal in May 2018. With respect to non-cleared markets, the CSDR buy-in framework has some significant differences to current contractual buy-in arrangements. Firstly, and quite importantly, it is no longer a discretionary right to issue a buy-in against a failing counterparty, but a legal obligation. Furthermore, there is little flexibility over the timing of the process. In the case of bonds, the buy-in process has to be initiated after the trade has failed for seven business days (known as 'the extension period'). Then the buy-in itself must be completed within another seven business days (including appointing the buy-in agent, executing the buy-in, and settling the buy-in). For non-cleared trades, a buy-in agent must be appointed to execute the buy-in.

Cash compensation (cash settlement)

If the CSDR buy-in is not possible within the prescribed seven business day timeline (say, because the securities cannot be found), the initiating party has the choice of electing to attempt the buy-in one more time, again within seven business days (known as the 'deferral period'). Should the initiating party elect not to attempt to buy-in one more time, or if the second attempt is also unsuccessful, then the buy-in will be resolved through a 'cash compensation' process. This is essentially a cash settlement of the original trade, with it being closed-out at a reference price based on current market levels.

SFTs

CSDR buy-ins will also apply to securities financing transactions (SFTs) with terms of 30 business days or more. This creates a number of issues for in-scope SFTs, such as the economics of buying-in the failing start leg of a trade (essentially this would replace the short-term loan of securities with an outright purchase), the treatment of open-trades,[14] and the logistics of buying-in a basket trade (such as triparty).

However, the CSDR buy-in framework also has indirect implications for out-of-scope SFTs. SFTs and outright trades are often dependent. For example, a party could sell a bond that is currently out on repo. If the recall of the repo fails, this could cause the sale to fail, leading to a buy-in. If the costs of being bought-in cannot be passed on to the failing repo party, this increases the risk of lending securities.

The 'CSDR put'

Another unique feature of the CSDR buy-in framework is an asymmetric treatment in the way that the buy-in or cash compensation differential payments are made between the trading parties. As already described, the intended outcome of a buy-in is to restore the parties to a transaction to the position they would have been in had the trade settled as intended. This means that the payment of the differential in the value of the original trade and that of the buy-in is made in either direction between the failing seller and the failed-to purchaser, depending on which is higher or lower. The same principle applies to cash settlement. The CSDR framework, however, only provides for payments to be made in one direction, from the seller to the purchaser (for both buys-ins and cash compensation). In the case of the buy-in price or cash compensation value being lower, the payment that would normally flow from the purchaser to the seller is 'deemed paid'. This anomaly is attributed to an error in the original Level 1 regulation which has the payments going in the wrong direction. The result is the economic equivalent of any seller of securities also writing an at-the-money put option that becomes active in the event of a buy-in (or cash compensation). This creates even more risk for sellers (and indirectly lenders) of securities and is thought to be unintended.

ICMA has proposed to ESMA and the European Commission that trading parties should be able to contract to settle any buy-in or cash compensation differential symmetrically. This could be achieved through existing contractual agreements (such as the ICMA Buy-in Rules) or other arrangements negotiated between trading parties.

CSDR pass-ons

There are no provisions in the CSDR buy-in framework for a pass-on mechanism. As the regulation is written, every settlement fail would trigger an independent buy-in after seven business days, even in the case of failing transaction chains. The recitals in the regulation do suggest that some form of pass-on facility would be welcomed, and ESMA has asked the industry to propose a possible pass-on mechanism to enhance the buy-in framework.[15] However, it is important to consider that pass-ons will not work unless the asymmetry in the buy-in and cash compensation payment process (the 'CSDR put') is resolved.

Scope and timing

Settlement Discipline will apply to all transactions intended to settle on an EU CSD or ICSD in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances, which are admitted to trading or traded on a trading venue or cleared by a CCP.

This will apply to all trading level entities, regardless of their domicile, that enter into such transactions that settle on an EU CSD, whether directly as CSD members, or indirectly via a settlement or clearing agent (a 'CSD participant'). The regulation requires that all parties in the settlement chain shall establish contractual arrangements with their relevant counterparties that incorporate the buy-in process requirements. Furthermore, CSD participants are required to establish the necessary contractual arrangements with their clients to ensure that the buy-in requirements are enforceable in all the jurisdictions to which parties in the settlement chain belong. Thus, the extraterritorial impacts could be quite extensive.

The CSDR settlement discipline requirements, including the mandatory buy-in regime are officially due to be applied from September 2020. This is expected to be extended until at least November 2020 due to a technical issue relating to cash penalties.

14 Open-trades are essentially an efficient way of rolling one-day trades. The end-leg is not booked until either of the parties elects to end the transaction. Since there is no intended end-leg at the start of the trade, it is not clear whether they are in-or out of scope.

15 ICMA is working with other associations to design a potentially viable pass-on framework, similar to discretionary pass-ons, but that is also consistent with the rigidity of the CSDR buy-in requirements.

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