International
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Association

News from the International Capital Market Association (ICMA)

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26 June 2018

ICMA publishes new report on the CSD regulation: 'How to survive in a mandatory buy-in world'

The International Capital Market Association (ICMA) has today published a report on the potential market consequences of one of the provisions of the Central Securities Depository Regulation (CSDR), entitled: 'How to survive in a mandatory buy-in world'.

While CSDR deals mainly with the regulation of Europe's settlement systems, it contains a section on 'settlement discipline', which includes measures to improve settlement efficiency, such as cash penalties for fails. Among these is the provision for mandatory buy-ins. 'How to survive in a mandatory buy-in world' seeks to explain the additional market risks and economic uncertainties the CSDR buy-in regime will create for bond market participants, both buyers and sellers, as well as intermediaries and lenders of securities. It explores the adverse and often conflicting behavioural incentives which will face market participants as they try to minimise these risks and the potential to incur losses beyond their control.

Martin Scheck, ICMA's Chief Executive said: "The CSD Regulation, while undoubtedly well-intentioned, will in one respect present major challenges for anyone transacting business in the European cross-border bond markets. This report prepared by ICMA's secondary bond market committee of active bond market participants, aims to make clear the consequences of making buy-ins mandatory, well in advance of the regulation coming into force in two years' time".

What is a buy-in?

'Buy-ins' are nothing new, and are a well-established remedy for failing trades, allowing failed-to purchasers to source securities elsewhere, and any price differential between the original and new transaction being settled between the original parties. The ICMA Buy-in Rules, for instance, are used widely in the international cross-border bond markets. Importantly, such buy-in mechanisms are discretionary (the failed-to buyer has the right, but not the obligation to execute a buy-in) and they do not seek to change the economics of the original trade (rather they aim to restore the parties to the position they would have been in had the original transaction settled). The CSDR mandatory buy-in framework, however, is different.

What will change under the new rules?

Firstly, as the name suggests, buy-ins will no longer be at the discretion of the failed-to buyer. Rather, the failed-to buyer will be legally obliged to execute a buy-in against their failing counterparty, regardless of whether it is economically advantageous to do so or not. Also, the timing of the buy-in is mandated: 4 business days after intended settlement for liquid equities, and 7 business days after intended settlement for illiquid equities and bonds.

Secondly, CSDR buy-ins do not look to restore the parties to the original position they would have been in had the trade settled. In many cases the buy-in will change the economics of trades. This also applies to transaction chains, where parties who may not be responsible for the fail could also find themselves being economically disadvantaged. Thirdly, in the case that a buy-in is not possible within a specified timeline, the original transaction will be cancelled, and the failing seller will pay cash compensation to the failed-to buyer. Again, the buyers of securities have little or no control of this process.

In light of this 'How to Survive in a Mandatory Buy-in World' provides five 'tips'[1] for surviving in a mandatory buy-in world:

(i) Only buy for guaranteed delivery
(ii) Never sell short
(iii) Think twice before lending out securities
(iv) Buy-in immediately – do not wait
(v) Avoid settling on EU regulated CSDs (as well as EU trading venues and CCPs)

The regulatory technical standards (RTS) for the CSDR mandatory buy-in framework were adopted by the European Commission in May 2018. It is currently being scrutinized by the EU Council and European Parliament and is set to be published in the Official Journal in September 2018. It will come into force in September 2020, and will affect all trading entities, globally, that settle trades on EU regulated ICSDs and CSDs, transact on EU regulated trading venues, or clear through EU regulated CCPs.

Notes for editors

International Capital Market Association (ICMA)
ICMA is the trade association for the international capital market with 540 member firms from more than 60 countries, including issuers, banks, asset managers, central banks, infrastructure providers and law firms. It performs a crucial central role in the market by providing industry-driven standards and recommendations for issuance, trading and settlement in international fixed income and related instruments. ICMA liaises closely with regulatory and governmental authorities, both at the national and supranational level, to help to ensure that financial regulation promotes the efficiency and cost effectiveness of the capital market
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[1] ICMA wishes to emphasize that the 'tips' provided in this paper are not recommendations; rather they are intended to illustrate the adverse behavioural incentives arising from the design of the CSDR buy-in framework.