

CSDR Mandatory By-ins and non-cleared Securities Financing Transactions (SFTs)

Frequently Asked Questions

March 2020

Q1: Are securities financing transactions intended to be in scope of the CSDR mandatory buy-in requirements (due to come into force from February 1, 2021)?

A: Yes. The CSDR Settlement Discipline measures, which include the mandatory buy-in provisions, are intended to apply to all transactions intended to settle on an EU/EEA CSD¹ in transferable securities, money-market instruments, units in collective investment undertakings, and emissions allowances,² which are admitted to trading or traded on a trading venue or cleared by a CCP.³ In most cases this would be expected to include securities financing transactions (SFTs), including repos and securities lending.

However, the regulation provides an exemption for certain *operations composed of several transactions including securities repurchase or lending agreements*.⁴ In the Regulatory Technical Standards (RTS) this is effectively specified as SFTs with maturities of 30 business days or less: *the buy-in process shall be considered ineffective where the intended settlement date of the second transaction is set within 30 business days after the intended settlement date of the first transaction*.⁵

Q2: Are the CSDR buy-in requirements expected to apply to both legs of an SFT?

A: Yes. While it would seem unusual to execute a buy-in against the start-leg of an SFT, the wording of the regulation suggests that this is expressly intended. With respect to the exemption for certain SFTs, it states that the buy-in *shall not apply where the timeframe of those operations is sufficiently short and renders the buy-in process ineffective*.⁶ It also describes SFTs as being *operations composed of several transactions*. It would therefore seem that the drafters of the Level 1 viewed SFTs as several distinct transactions (a purchase/receipt and a sale/delivery), rather than a transaction in its own right. In which case, they may have assumed that it was possible to execute a buy-in against the first transaction, with no need to amend the second transaction. Hence, where an SFT is not

¹ Articles 1(1) and 1(2)

² Article 5(1)

³ Article 7(10)

⁴ Article 7(4)b

⁵ RTS: Article 22(2)

⁶ Article 7(4)b

excluded from the CSDR buy-in requirements,⁷ it is possible (and required) to initiate a buy-in against the failing start-leg of the SFT.

Q3: How do you buy-in an SFT?

A: It is expected that the buy-in process will be exactly the same for SFTs as for outright transactions. However, in the case of a failing start-leg, there are potentially different options for how this could or should be done:

- (i) One option is to cancel the entire SFT (both start- and end-leg instructions). This would effectively replace the borrow of securities with an outright purchase of securities, which may not be desirable from the perspective of the borrowing (receiving) party.
- (ii) Another option is to cancel only the start-leg instructions, leaving the original end-leg instructions open. So long as the buy-in is successful, this will effectively put the borrowing (receiving) party in the same position that they would have been in had the start-leg settled.
- (iii) In the case that only the start-leg instructions are canceled, there is a possibility that the buy-in is not successful and goes to cash compensation. In this instance, the borrowing (receiving) party will be left with a forward-date obligation to deliver securities to the original lending party (effectively the equivalent of an outright sale, since they have not received any securities to deliver back). In this scenario it may be preferable to cancel both legs, similar to option (i).

Non-failing (receiving) parties, however, retain the right to utilize the relevant provisions in their contractual arrangements before the end of the CSDR extension period (see Q9). In the case of a failing start-leg, both parties could also agree to cancel the trade.

Q4. In calculating the buy-in differential to be paid between parties, what happens in the case of haircuts?

A: The regulation does not anticipate the application of haircuts from the perspective of calculating the buy-in differential payment. It is therefore assumed that to calculate the appropriate differential between the buy-in value and the value of the relevant SFT-leg to be paid between the delivering and receiving parties, an adjustment will need to be made with respect to any haircuts being applied to the original SFT. The best practice recommendation is expected to be that in the case of a buy-in or cash compensation, the market value of the failing leg is adjusted for any applicable haircut when calculating the differential payment amount based on the value of the buy-in or cash compensation reference price.

This is further complicated by the fact that the regulation only provides for payments to be made from the delivering party to the receiving party (in the case where the buy-in price is higher than the original transaction price). However, it is widely expected that there will be regulatory guidance

⁷ Whether under Article 7(4)b and RTS Article 22(2), or otherwise

confirming that parties can agree contractually to settle the difference symmetrically, which will help to resolve any ambiguity related to haircuts.⁸

Q5: Will cash compensation also apply in the case of SFTs?

A: Yes. In the event that the buy-in is not successful and goes to the cash compensation process, this is expected to apply in the case of SFTs. Again, this would be in the case of both start-legs and end-legs. In terms of the differential payment, as with a buy-in, this will need to be adjusted to take into account any haircuts applied to the original SFT.

Q6: Are open SFTs in scope of CSDR buy-ins?

A: Without guidance from the regulators to the contrary, yes. The rationale for their inclusion is based on the Level 2 exemption for SFTs, which applies *where the intended settlement date of the second transaction is set within 30 business days after the intended settlement date of the first transaction*.⁹ Since open SFTs do not have an intended settlement date for the second transaction (i.e. end-leg), they are de facto in scope. Again, this would be expected to apply to both start- and end-legs.

The industry has requested Level 3 guidance that open SFTs be exempted, on the grounds that from an economic and risk perspective, they are essentially rolling short-dated trades. This would also be consistent with other regulatory treatment of open SFTs (such as LCR and NSFR). Note that this would be expected to apply to all SFTs where the earliest contractual termination date is 30 business days or less after the intended settlement date of the start-leg.

There is also no expectation, in the case of a clarification on an exemption for open SFTs, that such trades would 'roll' into scope after they have been open for 30 business days. The industry request is that all open trades be exempted based on the earliest contractual termination date from the intended settlement date of the start-leg.

Q7: Will it be possible to pass-on a buy-in against an in-scope SFT?

A: It is important to note that there is no pass-on mechanism in the CSDR buy-in framework. The industry has put forward a proposal to ESMA and the European Commission for a pass-on mechanism, largely based on the existing ICMA Buy-in Rules, and it is hoped that this will be given Level 3 approval before the implementation date. If a pass-on mechanism is approved, and adopted through firms' contractual arrangements (such as the ICMA Buy-in Rules and the GMRA), then it should be possible to pass-on buy-ins (and cash compensation) to and from in-scope SFTs. In theory this could apply to a failing start-leg or end-leg of an in-scope SFT.

⁸ This will also be necessary to provide for a workable pass-on mechanism.

⁹ RTS: Article 22(2)

Q8: Will it be possible to pass-on a buy-in against an out-of-scope SFT?

A: It is expected that in the case of out-of-scope SFTs, the existing contractual remedies for fails (i.e. those under the GRMA and GMSLA), including the mini close-out provisions, will continue to apply. These provisions are not the same as buy-ins (including pass-ons), which, in the case of the ICMA Rules, only apply to outright cash transactions, and expressly not to SFTs. Thus, while it may be possible to use a cash market buy-in price as the valuation reference price in determining the associated payment of a mini close-out against an SFT end-price,¹⁰ this is not a pass-on, and there is no contractual interoperability between a cash market buy-in and an SFT mini close-out. This is not expected to change with the introduction of CSDR mandatory buy-ins.

Q9: Is it possible to avoid going to a buy-in for a failing in-scope SFT?

A: Yes. In the case of settlement fails for in-scope SFTs, it is still possible to use the relevant contractual provisions (including the mini close-out) before the end of the relevant extension period (which in most cases will be seven business from intended settlement date). If the failing SFT is effectively terminated by the end of the extension period, the buy-in requirement is understood no longer to exist.

Market participants have indicated that this should become established market best practice in the case of failing SFTs, rather than going to a buy-in, particularly in the case of a failing start-leg.

Q10: Are basket trades, such as triparty and DBV in-scope?

A: Without guidance from the regulators to the contrary, yes. This would apply to start- and end-legs of triparty and delivery-by-value (DBV) with terms of 31 business days and longer (as well as potentially open trades).

The incidence of these types of transactions failing for longer than seven business days is likely to be extremely low. Furthermore, it would almost always be optimal to apply the relevant contractual provisions before the buy-in becomes mandatory. However, it is considered important that the industry secure Level 3 clarification of an exemption for such trades on the grounds that a buy-in against a fungible basket of substitutable bonds makes no sense.

Q11: What contractual work is being undertaken to support implementation of CSDR buy-ins for SFTS?

A: Article 25 of the RTS requires that participants *shall 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*. ICMA is currently working with external counsel to develop an Annex for the GMRA (while ISLA are working on a parallel Annex for the

¹⁰ In the case of the GMSLA, it is possible to include associated buy-in costs in the determination of the mini close-out valuation. However, 'buy-in costs' are not defined, and it is not clear whether this is intended to include the 'buy-in premia' (i.e. the difference between the buy-in price and the **prevailing** market price). It is the buy-in premium that is the biggest risk (and cost) to bought-in parties.

GMSLA) to incorporate the buy-in requirements for in-scope SFTs. The Annex will also be part of the annual GMRA legal opinions process (covering 68 jurisdictions).

ICMA is also working with its members to establish market best practice for applying CSDR mandatory buy-ins to repos, which will be included in the ICMA ERCC Guide to Best Practice in the European Repo Market.

(Note that ICMA is also revising its Buy-in Rules to provide a contractual framework and market best practice to support implementation of the CSDR buy-in requirements in the international secondary bond markets. The ICMA Buy-in Rules only apply to outright transactions in international securities and do not apply to SFTs.)

Q12: How will firms and CSDs be able to identify in-scope SFTs?

A: Relevant parties in the settlement chain are expected to know whether SFTs are in or out of scope of the buy-in requirements. There is no requirement to identify in or out-of-scope SFTs at either the confirmation or settlement level.

There is a wider industry initiative to identify SFTs at the settlement level. However, this in itself would not indicate whether an SFT is in-scope of the CSDR buy-in requirements.

Q13: Will SFTs cleared through CCPs be treated in the same way as non-cleared SFTs?

A: While the regulatory requirements, including the SFT exemption, are largely the same in the case of cleared and non-cleared transactions, it may be that CCPs choose to bring out-of-scope transactions, such as short-dated SFTs, into scope of their own buy-in rules. In the case of cash settled securities, many CCPs do not distinguish between outright cash transactions and repos, which are pooled together for netting purposes. Given that aged-fails in CCP-cleared securities (usually liquid government bonds) seldom occur, the instances of buy-ins are likely to be rare, and so the benefits of continued netting of in- and out-of-scope transactions (including SFTs) may be optimal, even if that means bringing all SFTs into the scope.

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