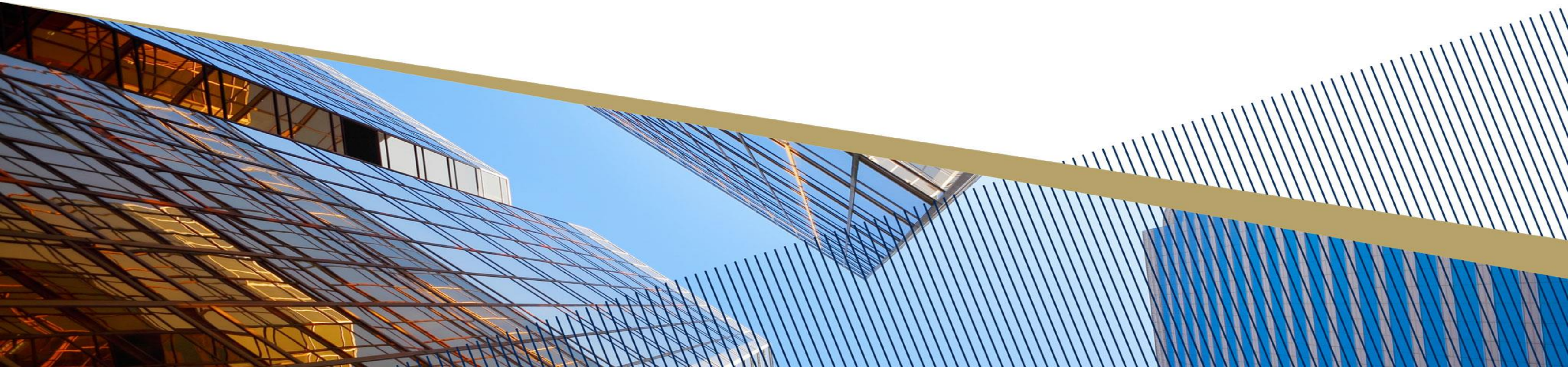
Mandatory buy in provision of the EU CSDR in the non-cleared bond & repo markets

June 2020



Outline

- How is the CSDR buy-in framework different?
- What are the challenges for firms caught under the buy-in regime, and what are ICMA and others doing about it?
- What are the potential implications for bond market functioning and liquidity?
- Lessons learned from the 2020 Covid-19 crisis

Outline

- **How is the CSDR buy-in framework different?**

Key differences between ICMA Buy-in Rules and CSDR mandatory buy-ins

ICMA Buy-in Rules	CSDR
Discretionary: can be initiated at any time from ISD+1	Mandatory: must be initiated following ISD+4 (liquid equities) or ISD+7
Non-defaulting party can elect time between notification and date of buy-in (4 to 10 days)	Non-defaulting party must start buy-in process following the extension period
Buy-in process can run indefinitely	Buy-in must be completed in 4 or 7 business days, with option to attempt ('defer') for one more attempt
No requirement to appoint a buy-in agent	Requirement to appoint a buy-in agent
Buy-in differential (buy-in price vs original price) is paid in either direction between seller and buyer depending on which is higher/lower.	Buy-in differential payment is asymmetrical and is only paid by the seller to the buyer where the buy-in price is higher. Where it is lower, the differential is "deemed paid".
Requirement for Guaranteed Delivery, with completion based on successful execution of the buy-in.	No requirement for Guaranteed Delivery, with completion based on successful settlement of the buy-in.
Cash settlement ("compensation") is possible, but not prescribed	Cash compensation is prescribed (also asymmetrically)
Pass-on mechanism to provide for single buy-in to settle settlement chains	No pass-on mechanism
Applies to all firms trading under ICMA Rules (usually members) in 'international securities'.	Applies to all transactions intended to settle on an EU/EEA CSD 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.

[1] Defined as a security intended to be traded on an international, cross-border basis (ie between parties in different countries), and capable of settlement through an international central securities depository or equivalent.

The CSDR mandatory buy-in asymmetry

Level 1: Article 7(6)

Without prejudice to the penalty mechanism referred to in paragraph 2, 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 no later than on the second business day after the financial instruments have been delivered following the buy-in.

RTS: Article 35

Payment of the price difference

1. Where the price of financial instruments referred to in Article 5(1) of Regulation (EU) No 909/2014 agreed at the time of the trade is lower than the price effectively paid for those financial instruments pursuant to Articles 27(10), 29(10), and 31(10), the failing clearing members, failing trading venue members or failing trading parties shall pay the price difference to the CCP, receiving trading venue members or receiving trading parties, as applicable.
Where transactions are cleared by a CCP, the price difference referred to in the first subparagraph shall be collected from failing clearing members by the CCP and paid to the receiving clearing members.

2. Where the price of the shares agreed at the time of the trade is higher than the price effectively paid for those shares pursuant to Article 27(10), Article 29(10) and Article 31(10), the corresponding difference referred to in Article 7(6) of Regulation (EU) No 909/2014 shall be deemed paid.

* Footnote added by ICMA. This would normally be expected to read “lower”, rather than “higher”, to be consistent with market practice. In the case that the price agreed at the time of the trade is *higher* than the price paid for the execution of the buy-in, the corresponding difference is normally paid **by** the receiving party **to** the failing party.

Outline

- **What are the challenges for firms caught under the buy-in regime, and what are ICMA and others doing about it?**

Identified challenges to implementing the CSDR mandatory buy-in provisions

- Scope and application
  - Certain SFTs (open, basket trades)?
  - How to buy-in an SFT?
  - Margin/collateral movements?
  - Finding a buy-in agent?
  - Pass-ons / multiple buy-ins?
  - Establishing the appropriate reference price (“market value”) for cash compensation?
  - Dispute resolution?

- Enforceability
  - Contractual arrangements (Article 25)?
  - Extraterritorial application?
  - Monitoring and sanctions?

- Impacts for market liquidity
  - Bond markets?
  - Repo and securities lending markets?

What is ICMA doing about CSDR buy-ins? Implementation: non-cleared Bond Markets

Updating the ICMA Buy-in & Sell-out Rules

- Providing a more efficient contractual buy-in process before the CSDR requirements apply
- Providing a contractual framework and market best practice to support implementation, post-extension period
- Providing contractual solutions to some of the regulation’s more problematic challenges
- Applied through ICMA membership and/or incorporated by reference in Terms of Business

Pre-extension Period (‘PEP”) Buy-in

- Similar to existing ICMA Buy-in Rules
- Can be executed up until the end of the relevant extension period
- Symmetrical price differential payments
- Guaranteed delivery
- Pass-on mechanism
- Ability to negotiate cash settlement

CSDR Buy-in

- CSDR compliant (mirrors regulatory buy-in provisions)
- Intended to allow for contractual enhancements such as symmetrical price differential payments and pass-ons (subject to regulatory guidance)

What is ICMA doing about CSDR buy-ins? Implementation: non-cleared Repo Market

Developing a GMRA CSDR-SD Annex

- Annex intended to support compliance with CSDR-SD requirements in the case of in-scope repo transactions
- Developed in parallel with ISLA's work on a GMSLA CSDR-SD Annex
- Expected to be bilaterally applied (multilateral amendment mechanisms will also be considered)
- Original market request to include contractual enhancements (symmetrical payments, pass-ons, etc.) likely to be challenging due to time constraints and lack of regulatory guidance
- Contractual enhancements to support additional commercial considerations possibly to be supported in a second phase (could be after 2021 'go live').

Establishing market best practice

- Possible best practice to use existing contractual provisions before the end of the extension period (to avoid going to a CSDR buy-in)
- How to buy-in a SFT (start-leg/end-leg/cash compensation)
- Adjusting for hair-cuts in determining differential payments
- In March 2020, ICMA published FAQs on CSDR mandatory buy-ins and Securities Financing Transactions. The FAQs are intended to outline considerations and, where possible, to provide clarity with respect to the application of CSDR buy-ins in the case of repos and other SFTs. The FAQs will be updated in light of new guidance from ESMA and agreed market best practice.

What is ICMA doing about CSDR buy-ins? Advocacy

- **Raising awareness of scope, details, and potential implications**
  - In particular non-EU entities and smaller buy-sides

- **Ensuring that ESMA is aware of industry implementation challenges**
  - Lack of clarity on outstanding critical issues (asymmetry, pass-ons, scope, etc.)
  - Other potential issues (lack of buy-in agents, cash compensation provisions)

- **Continuing advocacy with regulators and policy makers with a view to delaying/amending the CSDR mandatory buy-in provisions**
  - ICMA's position is that cash penalties should be made more punitive as a less disruptive alternative to applying the mandatory buy-in regime
  - ICMA undertook a 2nd Bond Market Impact Study in fall 2019 (following the previous study of 2015)
  - In January 2020, ICMA joined a cross-industry initiatives to request that the European Commission and co-legislators consider deferring implementation of the buy-in regime (until an assessment of the impact of penalties, as well as a detailed, quantitative analysis of potential impacts of the regime).
  - ICMA's Asset Management and Investors Council (AMIC) is also working with other buy-side associations to raise the concerns of the European and international asset management industry.
  - In May 2020, ICMA wrote to the Commission and ESMA again, outlining concerns related to a lack of Level 3 guidance and also to how the buy-in regime would have impacted the recent Covid-19 related market stresses.

What is ICMA doing about CSDR buy-ins?

Requests for regulatory clarification

- **Addressing the asymmetric payment provisions for buy-in and cash compensation**
  - In August 2018, ICMA proposed that trading parties could use contractual arrangements (such as the ICMA Buy-in Rules) to settle the buy-in and cash compensation price differential symmetrically.
  - This has been followed-up with an official Q&A submission as well as further documentation and discussions to argue the importance of symmetrical payments.
- **Providing for a pass-on mechanism**
  - In March 2020, ICMA submitted Q&As to ESMA outlining the cross-industry buy-in pass-on mechanism to enhance the CSDR buy-in process. The submission is in the form of two separate Q&As: (i) **a pass-on mechanism between failing transactions with the same intended settlement date**; and (ii) **a pass-on mechanism between failing transactions that may have different intended settlement dates**. These proposals were developed as a cross-industry effort, led by ICMA and AFME, and are based on existing mechanisms widely used in the non-cleared markets (such as under the ICMA Buy-in Rules).
- **Exempting open-SFTs**
  - In February 2020, ICMA and ISLA, on behalf of the European repo and securities lending community, **submitted a Q&A to ESMA** requesting Level 3 guidance that open, and open-like, SFTs should be exempted from the CSDR buy-in requirements based on their earliest contractual termination date. This is in line with other regulatory treatments (e.g. for LCR and NSFR purposes) as well as general accounting practice. The results of a **survey** of ERCC and ISLA members on their treatment of open SFTs was also shared with ESMA.

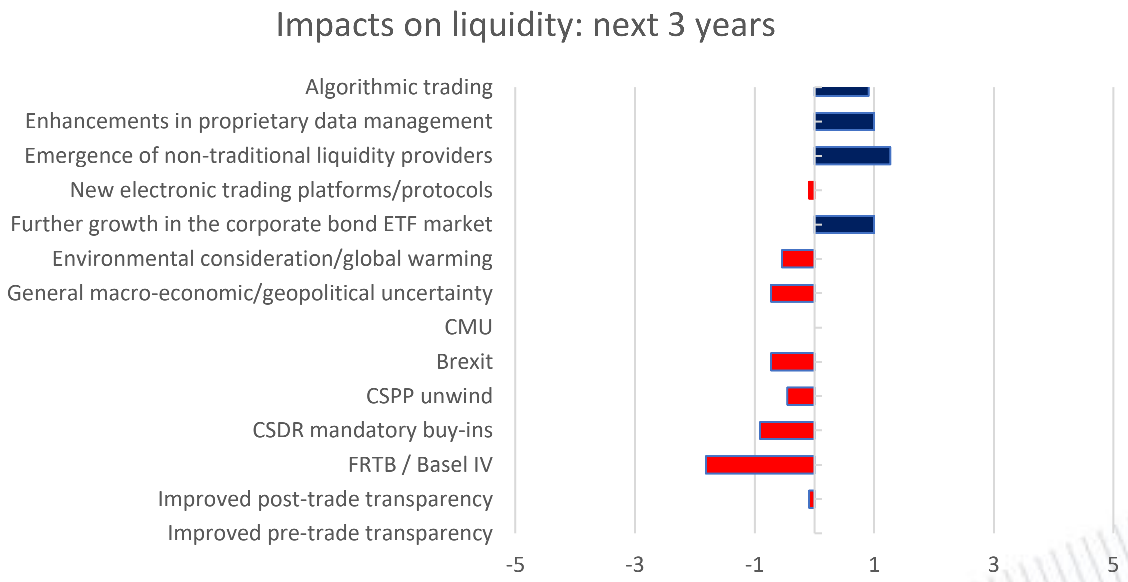
Outline

- **What are the potential implications for bond market functioning and liquidity?**

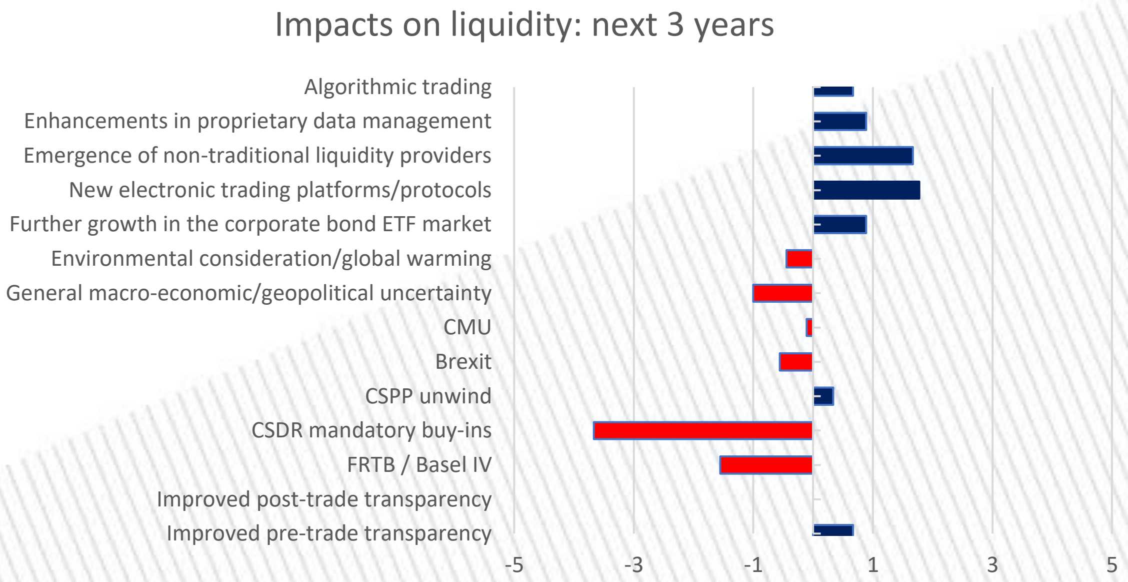
ICMA's 3rd study into the state and evolution of the European IG corporate bond secondary market*

In the next 3 years, what impact do you expect the following factors or initiatives to have on market liquidity, where -5 is very negative, +5 is very positive, and 0 is neutral?

Sell-side



Buy-side



* Final report published in March 2020

ICMA Bond Market Impact Study (2019)

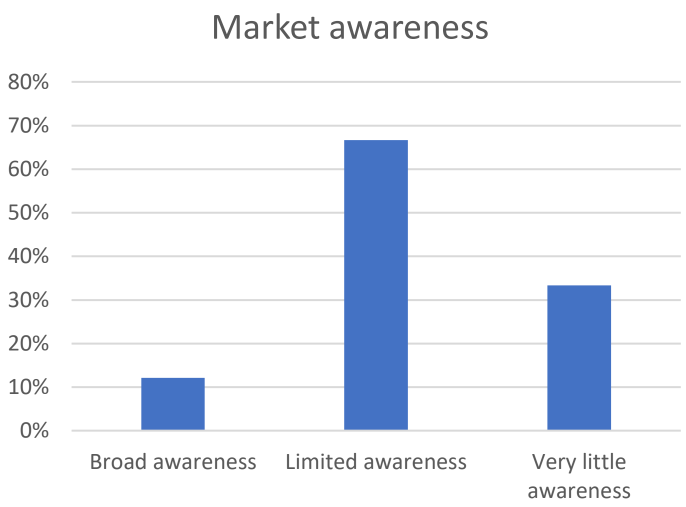
- **Follows up on ICMA's 2015 Bond Market Impact Study**

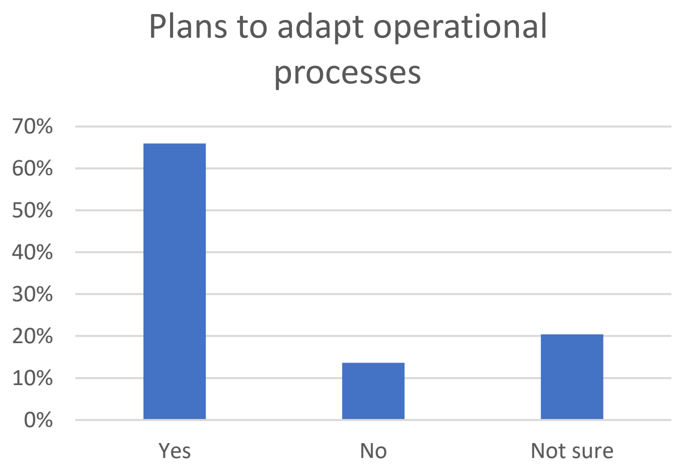
- **Study sets out to answer five questions with respect to the CSDR mandatory buy-in regime:**
  (i) What is the general preparedness of firms both from an operational and trading strategy perspective?
  (ii) How will sell-sides adjust their pricing and liquidity provision across a range of bond sub-classes?
  (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?

- **Methodology**
  - Survey based with three survey templates: sell-side, buy-side, repo and securities lending desks
  - 44 responses, representing buy-side firms (16), sell-side firms (16), and repo and securities lending desks (12).

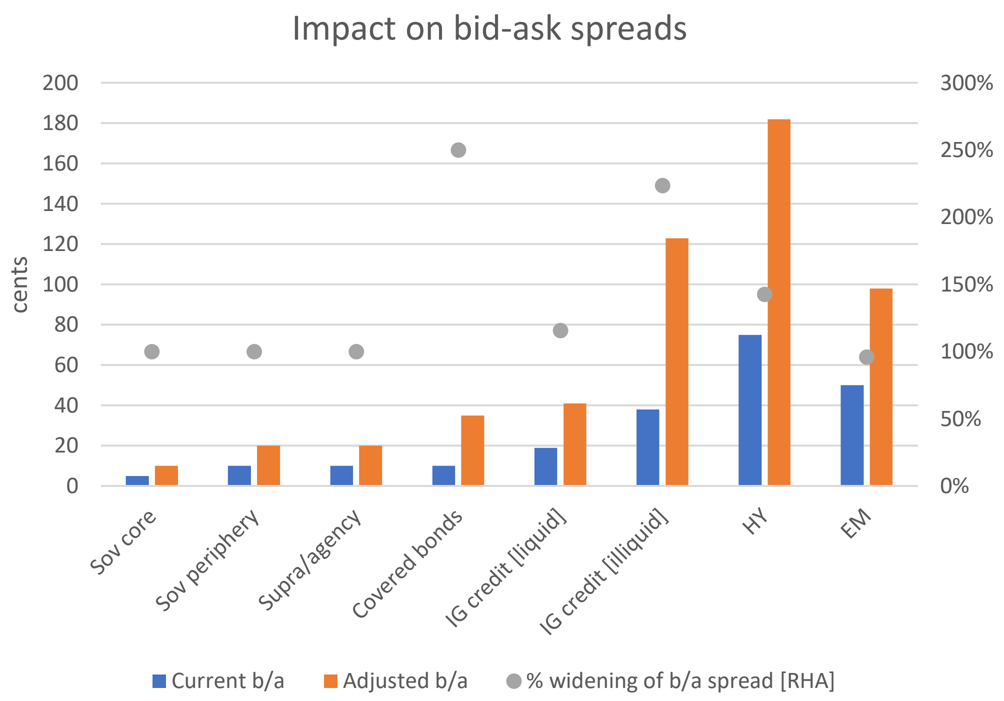
- Focus is on euro bond markets, but impacts are expected to extend to all securities settled on EU (I)CSDs

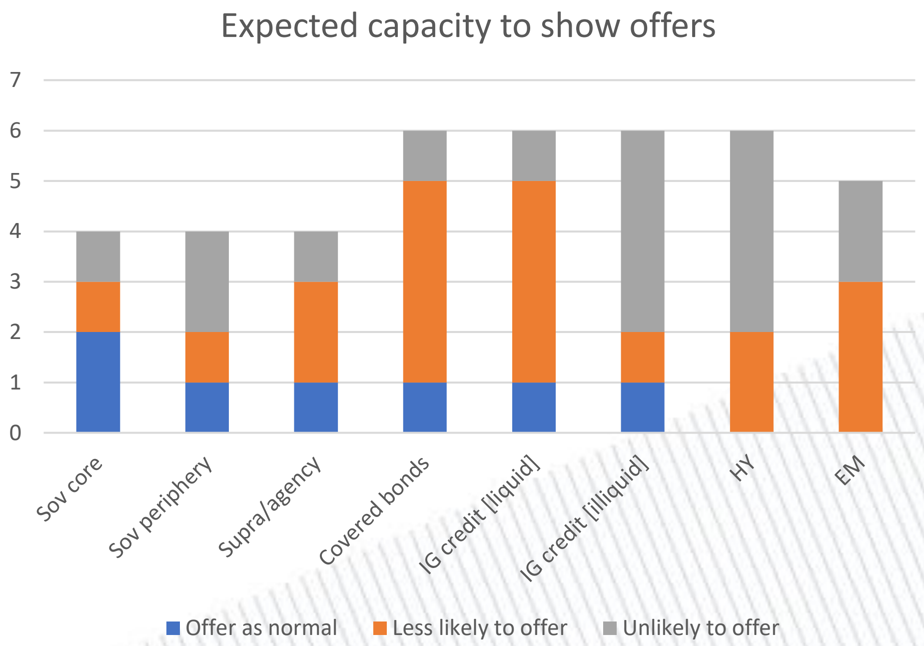
Awareness and preparedness



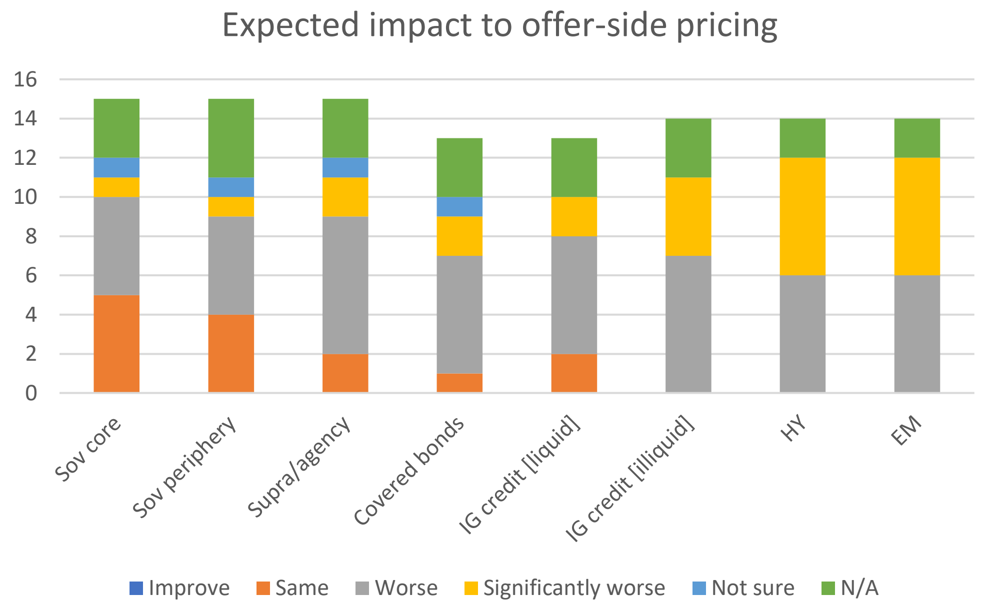


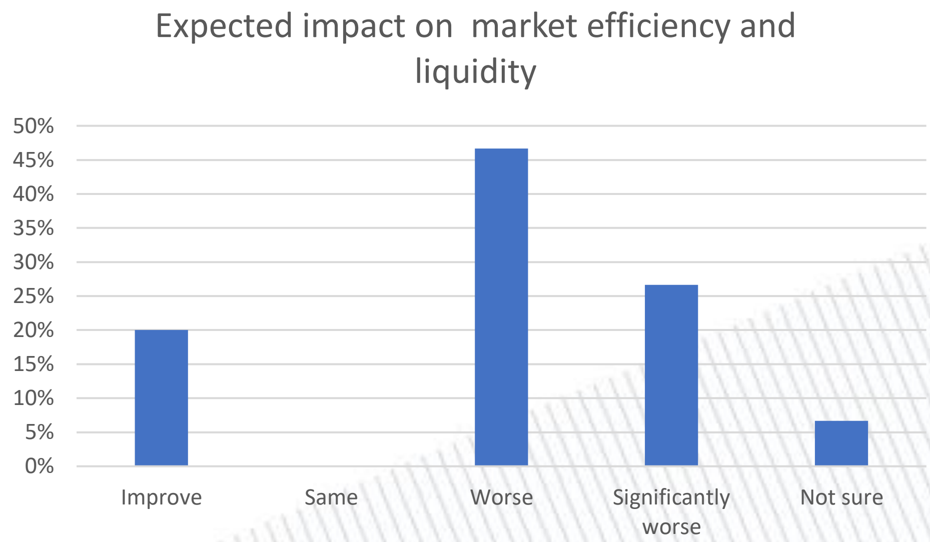
Sell-side pricing and liquidity



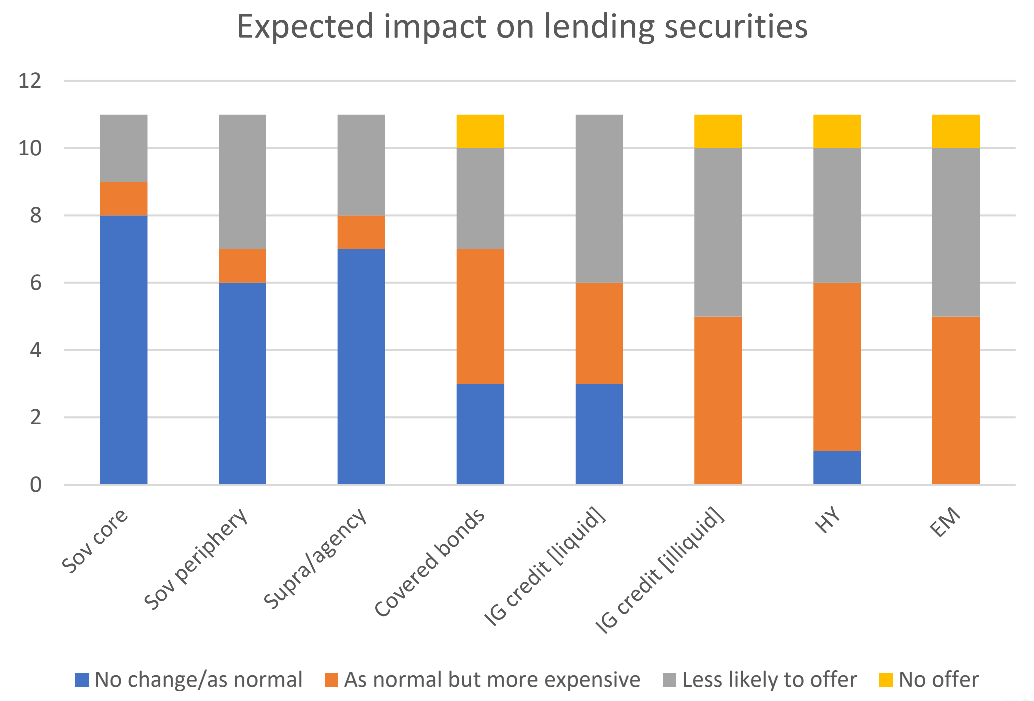


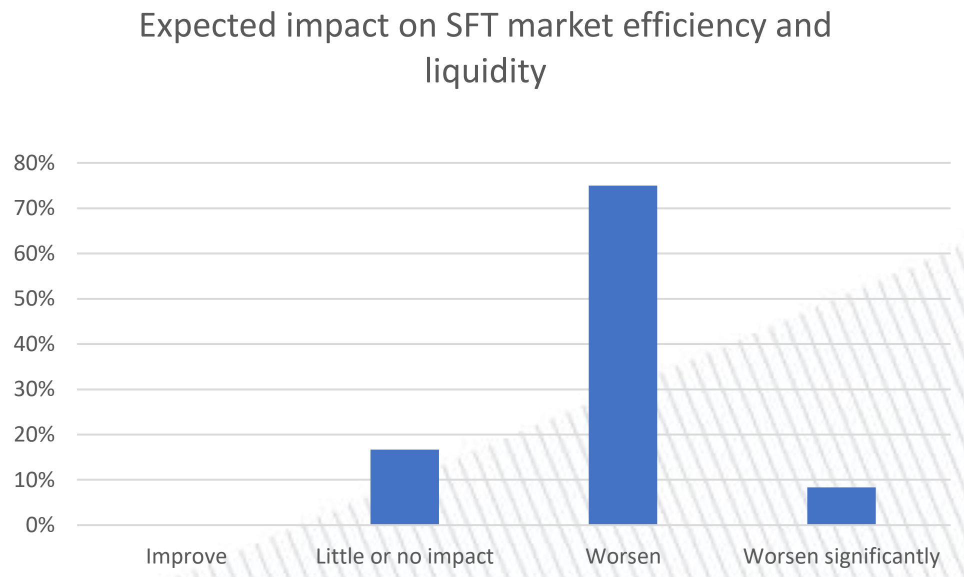
Buy-side expectations





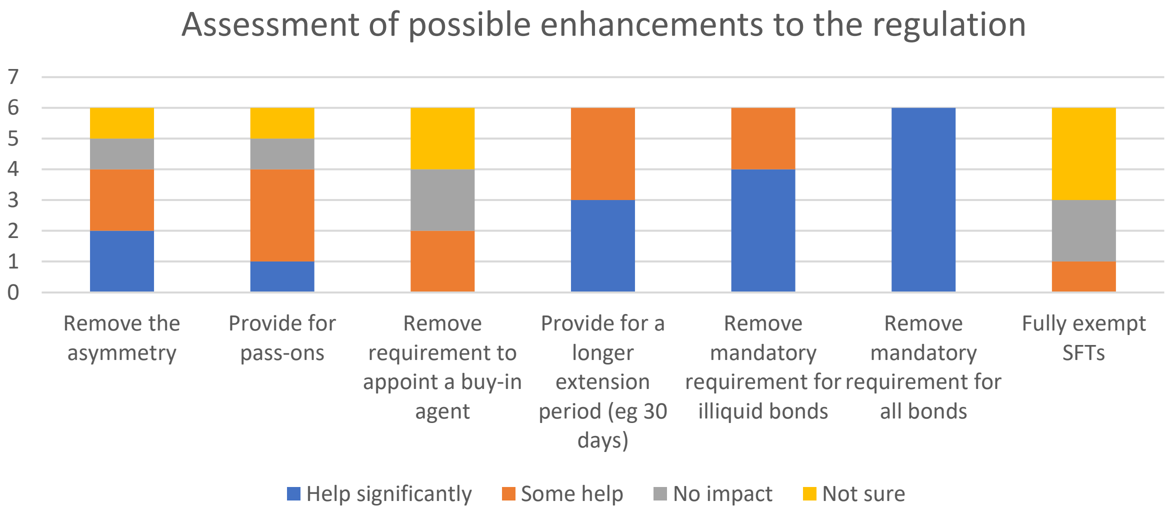
Repo and securities lending



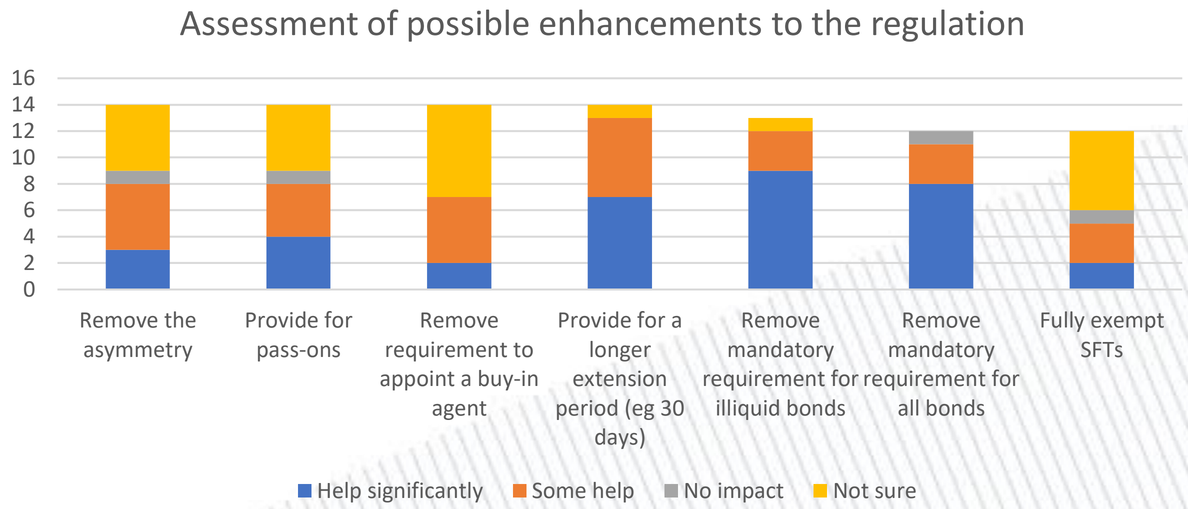


Possible enhancements

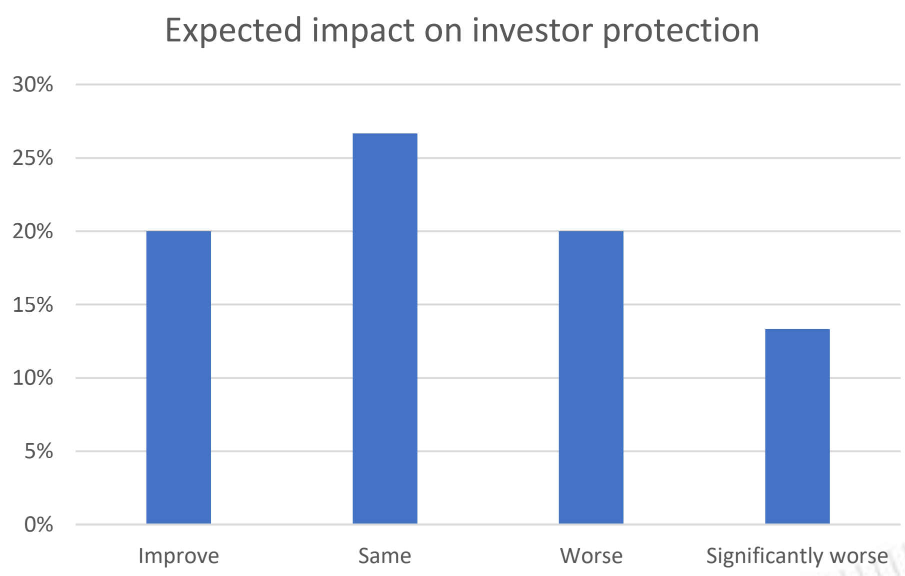
Sell-side



Buy-side



Expected impact on investor protection



Outline

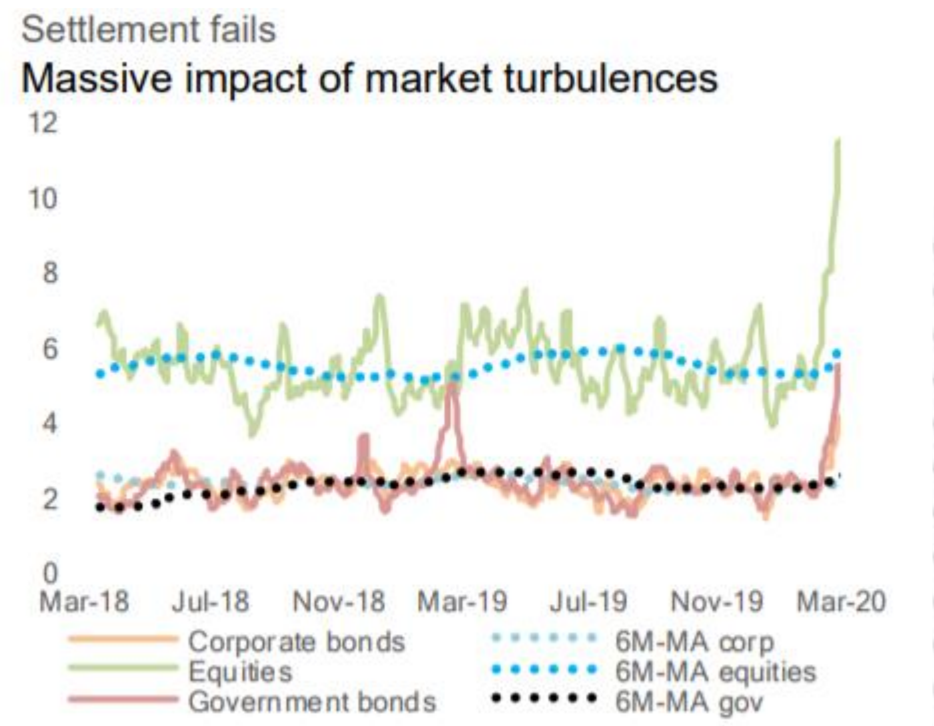
- **Lessons learned from the 2020 Covid-19 crisis**

2020 Covid-19 Crisis

- It is noted by a number of buy-side and sell-side participants that there was a sizeable, albeit temporary, increase in settlement fails during the height of the crisis. This is largely attributed to operational challenges related to transitioning middle- and back-office teams to disaster off-sites and home-working, as well the impact of lockdowns on outsourced settlement teams (such as those based in India), at a time when overall trading volumes were significantly above average.

- The general view of participants is that mandatory buy-ins would have turned a crisis into a catastrophe.
  - Firstly, the time and resources required to manage the buy-in process (which requires operational, trading, and legal input) would have been a significant drain on already stretched staff.
  - Secondly, trying to buy-in illiquid securities in an already stressed and often chaotic market would only have exacerbated market volatility, while compromising market stability.
  - And thirdly, anything that further restricts market-maker capacity would have been an additional blow to liquidity at a time when it was most needed.

Source: ICMA, 2020, [The European investment grade corporate bond secondary market & the COVID-19 crisis]()



Source: ESMA Risk Dashboard, May 2020

Resources

- May 2020: ICMA **Briefing note** on cash compensation provisions and bond markets
- March 2020: ICMA **FAQs** on CSDR mandatory buy-ins and SFTs
- November 2019: ICMA CSDR buy-in **impact study** for EU bond markets
- August 2019: ICMA **information brochure** on CSD Regulation mandatory buy-ins
- June 2018: **How to survive in a mandatory buy-in world**
- May 2017: ICMA **Position Paper** on CSDR Settlement Discipline

➢ ICMA CSDR settlement discipline: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-markets-regulation/csdr-settlement-discipline/

➢ ICMA CSDR-SD Working Group: https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/secondary-market-practices-committee-smpc-and-related-working-groups/csdr-sd-working-group/

❖ REGULATION (EU) No 909/2014 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

❖ 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