The urgent need to suspend and revise the CSDR Mandatory Buy-in Framework

An ICMA briefing note

July 2021 (updated)

As a matter of urgency, and in the best interests of the integrity of European capital markets, ICMA urges the relevant authorities to suspend the scheduled implementation timeline of the mandatory buy-in provisions under the CSD Regulation (CSDR) in order to instate critical amendments to the buy-in framework. Market participants strongly encourage the authorities to communicate, before September, their intention to suspend the CSDR mandatory buy in provisions.

The importance of settlement discipline

ICMA and its members, including European and global asset managers, investors, banks, broker-dealers, and market infrastructures, are committed to developing an efficient and effective post-trade ecosystem. Therefore, we fully support the objectives of the CSDR Settlement Discipline regime (SDR) and foster complementary market initiatives that strive to achieve the same outcome. ICMA supports the implementation of the SDR, including the cash penalty framework, **but cautions strongly against the 1 February 2022 implementation of the CSDR mandatory buy-in (MBI) framework**. The reasons for ICMA's objection to implementing the current MBI framework are:

- the MBI regime as currently designed in the Regulatory Technical Standard (RTS)[1] is not fit for purpose. It contains a number of structural flaws,[2] including many derived from Level 1 drafting, that will undermine the integrity of Europe's capital markets if implementation is attempted; and
- an MBI framework, even when revised, is expected to have significant detrimental impacts on secondary bond market liquidity and pricing. It will particularly affect the less liquid segments such as corporate bonds, with implications for the attractiveness of Europe as a centre for both capital raising and investment. This is further explained in Appendices 2 and 3.

While the merits and implications of a mandatory buy-in regime will be re-assessed as a part of the CSDR review, the **more immediate problem remains that the current design of the MBI framework is fundamentally flawed and therefore implementation should not be attempted before making critical**

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[1] Commission Delegated Regulation supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline

2 For further detail please see Appendix 1 and the ICMA's detailed response to the EC's Targeted consultation on the review of CSDR (2 February 2021)

amendments. Implementing the current MBI regime would be extremely burdensome and costly to all market participants, including many outside of the EU, and could diminish confidence in Europe's capital markets as a place to do business.

Meanwhile, there is broad confidence that the CSDR cash penalty regime, along with other initiatives currently being undertaken by the industry, has the potential to improve significantly EU settlement efficiency rates, across all asset classes. ICMA believes that the cash penalty regime should therefore be implemented as soon as possible, and given time to take effect, with penalty rates being recalibrated, if required, to provide a powerful incentive underpinning settlement discipline.

Critical revisions to the CSDR mandatory buy-in regime

It is widely understood that the CSDR MBI framework, as currently outlined in the RTS, contains a number of critical flaws that are likely to result in adverse outcomes for those to whom they apply: both investors (e.g. pension funds) and liquidity providers (i.e. intermediaries in the bonds markets). Some question whether the current framework is even implementable.

Many of these design faults were the subject of the recent European Commission Targeted Review of CSDR. These include (i) the requirement to appoint a buy-in agent; (ii) the lack of a pass-on mechanism; (iii) asymmetric differential payments; (iv) an unworkable methodology for cash compensation; and (v) a lack of clarity around scope and application. These are explained in Appendix 1 to this note. Solving for each of these flaws, in isolation, will not help with implementation. Rather they should be viewed as a package of necessary amendments and part of the much needed and extensive overhaul of the entire MBI regulatory framework.

There are currently more than 30 requests for clarification outstanding related both to the buy-in process and its scope, many of which have been referred to the Commission legal team. Clarification on most of these critical points is not expected before the implementation date of February 2022, largely due to the fact that they derive from the Level 1 drafting.

Complying with the MBI requirement

Article 25 of the RTS requires that all parties in the settlement chain have in place contractual arrangements to ensure enforceability of the MBI provisions in all relevant jurisdictions. This will entail a significant legal re-papering (modification of contracts) exercise on a global scale, covering numerous master agreements and terms of business. The scale of this exercise should not be underestimated - it is likely to impact up to 100,000 contracts per firm and take anywhere from 9 to 18 months. While it is not unusual for a new regulation to entail significant repapering, in this particular case there are a number of complicating factors to consider: (i) parties are being asked to import contractually a flawed and unclear MBI regime; (ii) the regulation is subject to a review, the result of which is uncertain; (iii) the regulation has extra-territorial range making client outreach more complex; and perhaps most concerning (iv) it is likely that the market will have to undertake a significant repapering exercise twice, creating legal complexity and uncertainty.

There are also significant challenges related to the operational and systems builds required to support the processing of MBIs under the proposed CSDR regime. Today, market buy-ins are processed manually, and while immensely time consuming (involving trading, operations, and legal), they are relatively rare. Market buy-ins are explained in Appendix 4. Under the MBI regime is it is likely that firms will be processing hundreds, possibly thousands, of buy-ins at any one time; thus automation will be critical. Again, it is expected that firms will need to make the necessary investments and IT builds to support operational implementation twice, particularly since the buy-in process is expected to be substantively revised.

Firms are already facing deadlines relating to investment in legal and operational implementation projects. **It would be far more efficient and less burdensome if the MBI framework were revised before implementation, and it is critical that this approach be communicated to the market prior to September.** One of the objectives of the Review, as stated in the European Commission's Report, is to reduce disproportionate burdens and costs related to settlement discipline.

Mandatory vs voluntary buy-ins

While there is powerful evidence to suggest that a mandatory buy-in regime would be detrimental to the efficiency and stability of markets, we note that discretionary ('voluntary') buy-ins already exist in a number of non-cleared markets, such as the international bond markets.[3] The legally enforceable right to buy-in a failing counterparty, and the process for doing so, is provided through contractual arrangements between the trading parties.[4] Such contractual provisions have been designed with specific markets, instruments, and transaction types in mind. For transaction types where buy-ins are not the appropriate solution, other contractual provisions to remedy fails also exist, such as those applied in the repo and securities lending markets.[5] Where there are appropriate contractual solutions already available, we do not believe that there is a need to duplicate these through additional EU legislation. Furthermore, if an 'optional' buy-in process is to be introduced through regulation, it will be important that it is does not conflict with, or undermine, these existing, established remedies, nor result in unnecessary and duplicative contractual remediation across the industry.

Conclusion

While ICMA fully supports CSDR-Settlement Discipline, in particular the penalty framework, it is important that the MBI framework be reviewed and revised before attempting implementation. Given the herculean industry undertaking required to support implementation of the MBI regime, which

[3] International securities are defined as securities that are intended to be traded across different jurisdictions and are capable of being settled on at least one of the International CSDs.

[4] Such as the ICMA 'Buy-in Rules': part of the ICMA Secondary Market Rules & Recommendations (link)

[5] These are provided for in GMRA and GMSLA agreements. The Global Master Repurchase Agreement (GMRA) is a model legal agreement designed for parties transacting repos and is published by the International Capital Market Association (ICMA), ICMA FAQs on repo, Q 19 What is a GMRA? The Global Master Securities Lending Agreement (GMSLA) may be used as a standard master agreement for securities lending transactions in the cross-border market. (https://www.islaemea.org/gmsla-title-transfer/)

extends far beyond EU regulated entities, ICMA would urge the authorities to **delay implementation until after the necessary amendments have been made. Furthermore, given the relatively short time to February 2022, this delay should be communicated at the earliest opportunity to avoid further unnecessary costs and burdens for the industry.**

Appendix 1: Critical flaws in the current MBI framework

- **The requirement to appoint a buy-in agent**
  The regulation requires the appointment of a buy-in agent (BIA) – a neutral third-party to execute the buy-in - at the start of the MBI process.[6] As of today there is only one entity that has put itself forward to act as a BIA. Many buy-side firms have expressed concern that they sole BIA model may not be compatible from both an operational and legal perspective. They also note that onboarding is at the fund level not the manager level, which will entail hundreds or even thousands of individual funds being required to onboard. Others have voiced concerns about the costs of using the sole BIA, noting that in effect this is a monopoly. There is also broad skepticism that an auction model is inappropriate for buying-in illiquid bonds and is likely to fail.

  ICMA members who could potentially act as buy-in agents have explained that they have chosen not to do so as they believe the current buy-in process in the RTS is not fit for purpose, that it will need to be revised, and that therefore it would be highly risky to invest in supporting a process that was widely expected to be substantively amended.

- **No pass-on mechanism**
  Existing buy-in mechanisms for the noncleared markets (such as the ICMA Buy-in Rules, usually provide for a pass-on mechanism. Settlement fails are often in the form of chains, where securities have been traded between several counterparties and a single fail can result in multiple onward fails. Rather than multiple buy-ins being executed between each party, a pass-on mechanism is a means of using one buy-in (usually by the final buyer in the chain) to settle the entire chain. As well as being highly efficient, this avoids the potential for market instability and excessive volatility with multiple buy-ins being attempted at the same time.

  The CSDR MBI framework does not provide for a pass-on mechanism. Every individual settlement fail in a chain will result in its own buy-in being initiated.

- **Asymmetric payment provisions**
  Buy-in mechanisms for the noncleared markets usually provide for the payment of the buy-in differential (the difference between the value of the original transaction and that of the buy-in transaction) to flow in either direction between the relevant parties, depending on whether the buy-in price is higher or lower than the original trade price.[7] This is intended to preserve the integrity of the original transaction (it also helps to facilitate pass-ons). CSDR MBIs only allow for the payment to be made in one direction (from the original seller to the buyer). This is the result of a drafting error in the Level 1 text which puts the payments going in the wrong direction. This creates additional risk to the failing seller, with theoretically open-ended costs, while creating the possibility for windfall profits for the buyer. It also means that a pass-on mechanism will not be possible. Some firms believe that it will still be possible to contract to settle the differential

[6] Buy-ins executed in the international bond markets under the ICMA Secondary Market Rules & Recommendations no longer require the appointment of a BIA. The initiator is able to execute the buy-in directly, subject to certain best execution criteria.
[7] Note that this has nothing to do with the buy-in cost to the party being bought-in, which is the difference between the buy-in price and the current market price. See Appendix 4.

symmetrically, while others hold that this would be in conflict with the regulation. There is no regulatory guidance on this matter.

- **Unworkable cash compensation remedy**
  Where a buy-in cannot be successfully executed within a prescribed timeframe, the regulation provides that the trade is cash settled in a process called 'cash compensation'. This requires the determination of a reference price, of which the cash compensation is calculated. For bonds, this is expected to be based on the previous day's closing price on the most active trading venue for the relevant security. This overlooks the fact that in many cases where a buy-in is not possible, this is because there is no available market. Therefore, there will be no price to reference. Accordingly, it is not clear how this cash compensation process is expected to work. It is likely that most CSDR buy-ins in illiquid bonds will end in cash compensation.

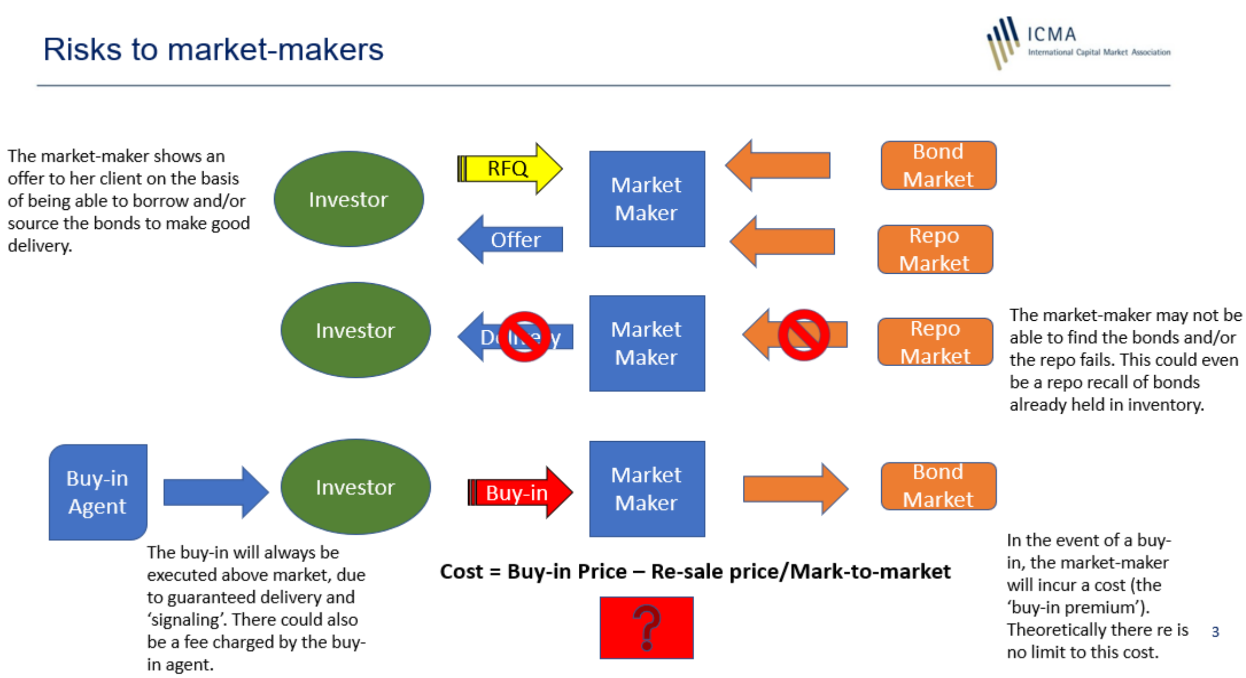
- **Lack of certainty around scope**
  There remains significant uncertainty around the scope of CSDR MBIs and whether the provisions apply to certain transactions: particularly transaction types where a buy-in would make little or no sense. These include intercompany transfers, margin postings, and open-SFTs. While the incidents of such transactions going to a buy-in are likely to be negligible, without clarification of exemption firms will need to undertake contractual remediation (amending existing contracts) with respect to such transactions in order to comply with the requirements.

Appendix 2: market-making and the impacts of MBIs on pricing and liquidity

As part of their role as liquidity providers, market-makers are often required to provide offers in securities that they do not hold on their books. For bonds, this is generally expected to be the case for around 20-25% of all sales. The market-maker will then look to obtain the securities, usually in the first instance in the repo market[8], and then later to buy them back outright in the market. Market-makers generally do not look to run short positions for very long, given capital costs and risk limits, and will try to buy back the securities as quickly as possible. In most cases they will successfully do so. In a few cases, however, they may struggle either to buy back the bonds or to source them in the repo market, leading to a settlement fail.

In these cases, the purchasing party, usually an investor, will have the discretionary right to issue a buy-in to enforce settlement (see Appendix 4). However, in most instances they may decide to accept and manage the resulting counterparty exposure and allow more time for the market-maker to source the bonds. This also provides the market-maker with more confidence to provide offer-side liquidity.

In the case of a buy-in, market-makers will incur costs, sometimes significant, which could affect their ability to provide liquidity in the future. This risk is illustrated below.

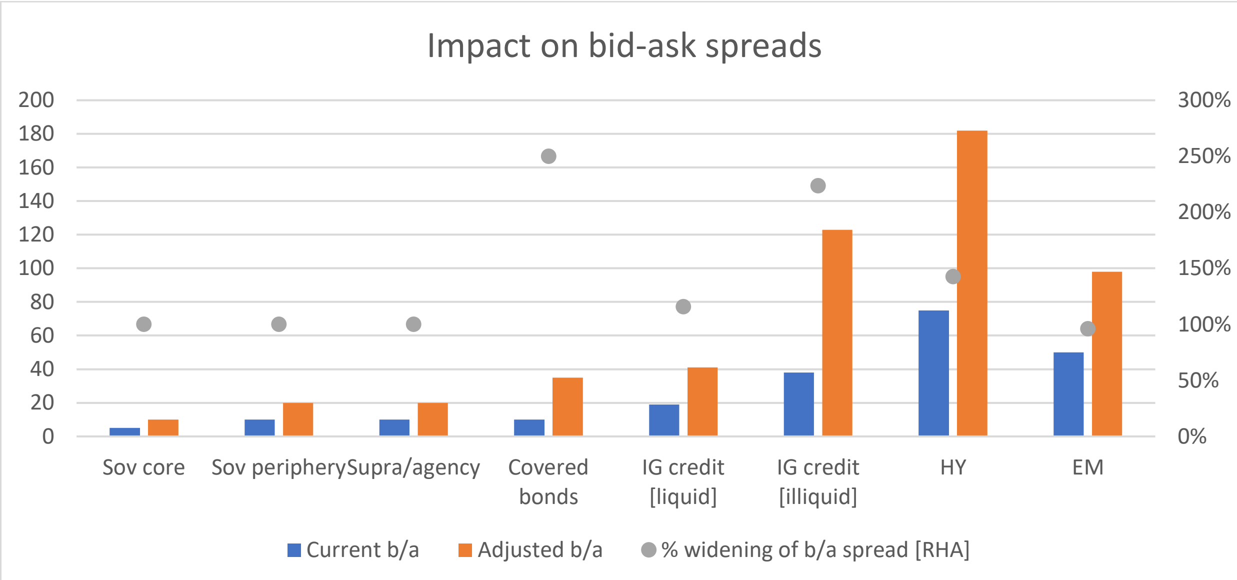


When the risk of a buy-in increases, market-makers naturally adjust for their assessment of this risk, either by adjusting their pricing (so a direct cost to investors) or by declining to show a price (so a loss of liquidity for the investor). Given that the CSDR MBI requirement will increase the probability of buy-ins being executed in the case of settlement fails, the risks to market-makers also increase when showing

[8] https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/icma-ercc-publications/frequently-asked-questions-on-repo/1-what-is-a-repo/

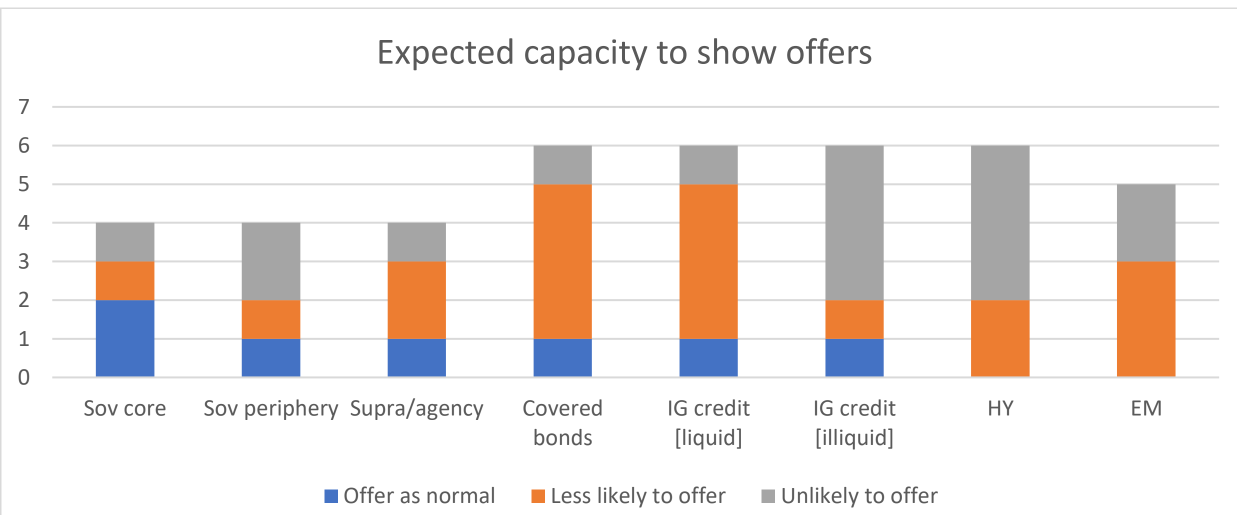
offers to clients. These impacts are estimated in a 2019 impact study[9] undertaken by ICMA and are illustrated below. Not surprisingly, bid-offer spreads widen significantly, particularly in the case of less liquid bond segments, such as corporates and non-core sovereigns. Similarly, the propensity to show offers also decreases with liquidity.

Change in market-making bid-offer for bonds not held in inventory (post CSDR MBI)



Source: ICMA impact study (2019)

Expected capacity to show offers in bonds not held in inventory (post CSDR MBI)



Source: ICMA impact study (2019)

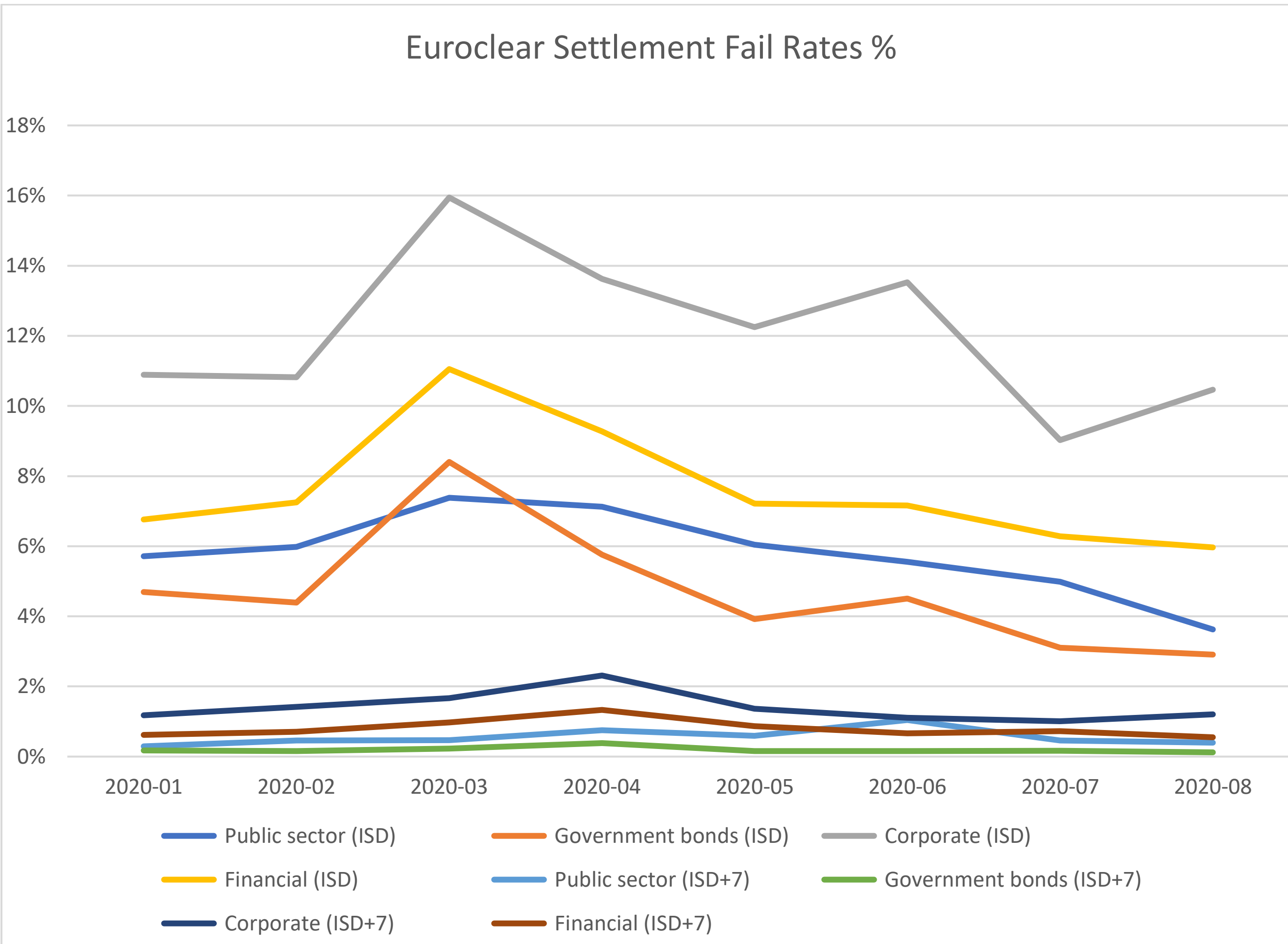
[9] See: https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/CSDR-Settlement-Regulation/Mandatory-buy-ins-under-CSDR-and-the-European-bond-markets-Impact-Study-271119.pdf

Appendix 3: settlement rates, expected buy-ins, and impact of Covid-19

Settlement efficiency rates in the European bond markets are generally considered to be quite high (certainly relative to equities and ETFs), although there is still room for improvement.

The below shows settlement efficiency rates, provided by Euroclear, for bonds over the period January-August 2020. The data shows rates both on Intended Settlement Date (ISD) and ISD+7, when the mandatory buy-in for bonds would be triggered. It can be seen that rates improve significantly between ISD and ISD+7 (e.g. on average from 95.3% to 99.8% for government bonds and from 87.9% to 98.6% for corporate bonds).

Euroclear settlement fail rates for bonds (Jan-Aug 2020)

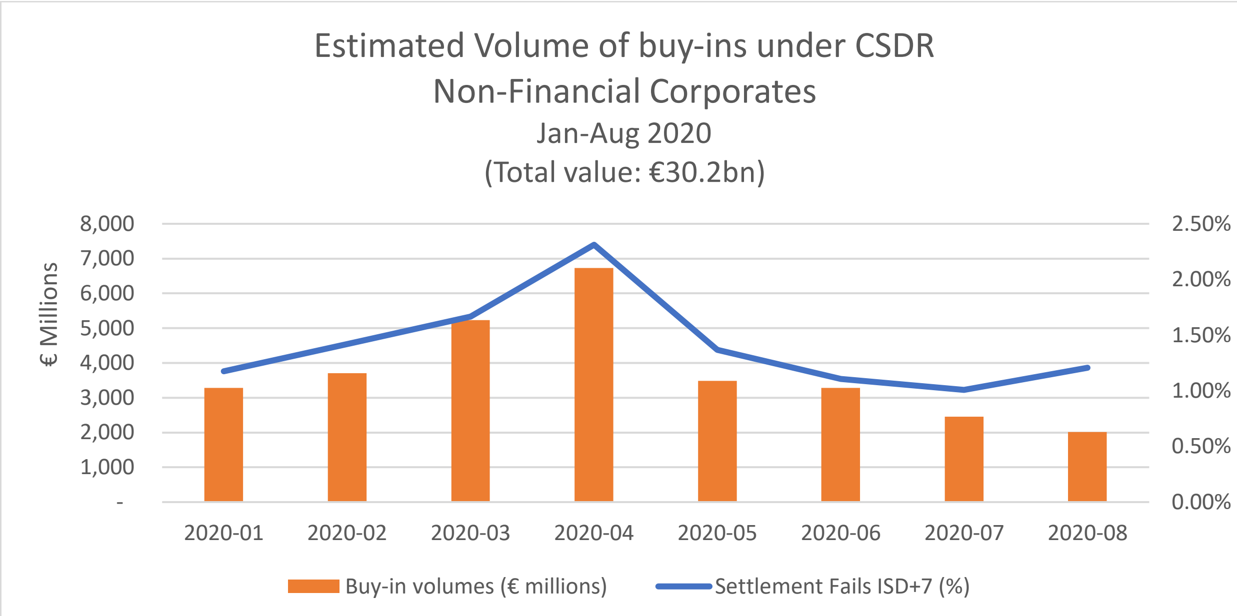


Source: ICMA analysis using Euroclear Bank data

While the percentage of settlement fails at ISD+7 is relatively low, in absolute terms this would trigger a significant volume of buy-ins. This is illustrated below by applying the Euroclear settlement efficiency rates on ISD+7 to total market volumes (using Bloomberg MiFID II/R data). As can be seen, the projected numbers run into many billions of euros.

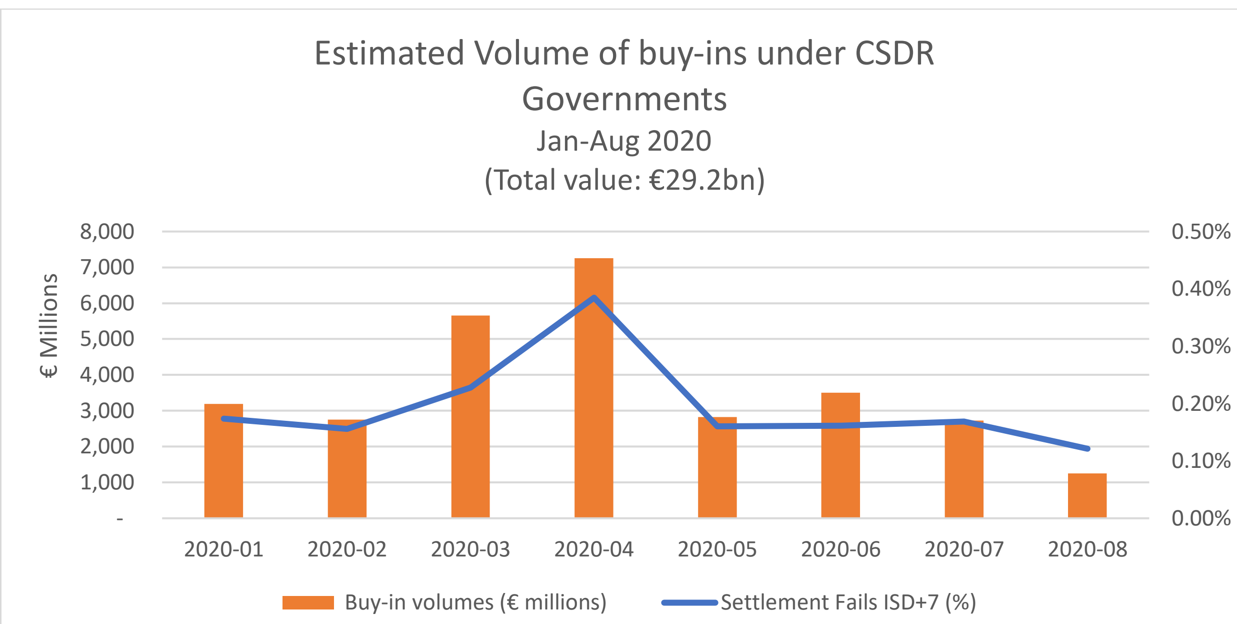
It can also be seen that these volumes would have increased dramatically during the March-April covid turmoil, when settlement fails increased sharply for technical reasons related to back- and middle offices transitioning to working remotely. This would also have been at a time when bond markets were at their most volatile and least liquid, raising concerns of procyclical risks

Estimated buy-in volumes for corporate bonds under CSDR MBI (Jan-Aug 2020)



Source: ICMA analysis using Euroclear Bank and Bloomberg data

Estimated buy-in volumes for government bonds under CSDR MBI (Jan-Aug 2020)



Source: ICMA analysis using Euroclear Bank and Bloomberg data

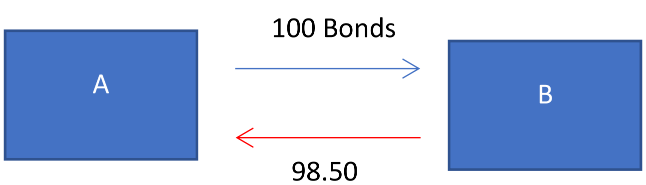
Appendix 4: market buy-ins

A market buy-in is a contractual remedy available to a purchasing counterparty of financial securities in the event that the selling counterparty fails to deliver the securities[10]. Where the selling counterparty fails to deliver on the agreed settlement date, the purchasing counterparty has the right to enforce delivery by instructing a third-party (a buy-in agent) to purchase and deliver the securities to replace the original transaction. Any differences between the price of the original transaction and the buy-in price are settled between the selling and purchasing counterparty. The purpose and effect of the buy-in process is to return all counterparties to the economic position they would have been in had the original transaction settled on the intended settlement date.

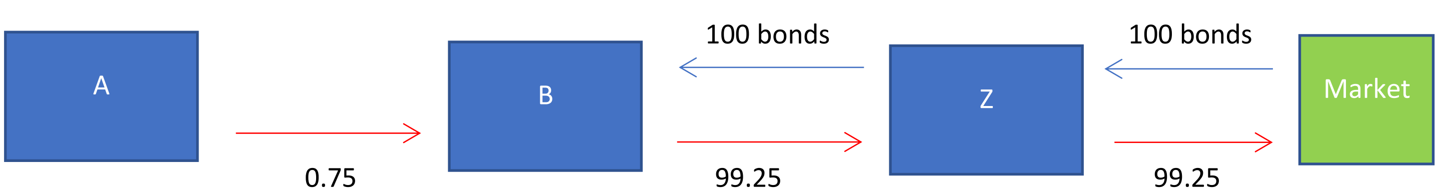
<u>Example of the buy-in process</u>

Counterparty A sells 100 bonds to counterparty B at price of 98.50.
The trade does not settle, and B elects to initiate a buy-in against A.
The buy-in agent (Z) purchases the bonds at a price of 99.25 and delivers them to B at the same price (99.25).
Simultaneously, B cancels the original settlement instruction with A.
A pays B the difference between the original transaction and the buy-in price, i.e. 0.75.
If A now re-sells (or marks-to-market) their original 100 bonds (at the market price of 99.25), both A and B will be in the same economic position they would have been in had the transaction settled.

The original transaction



The buy-in



The above diagram shows clearly how the buy-in restores the economic position of A and B. B receives the securities at the equivalent price of the initial transaction (99.25-0.75), and A, after re-

[10] It should be noted that in some instances the fail is caused by the purchaser, and not the seller, in which case the equivalent remedy is a 'sell out'. (CSDR does not provide a requirement or provisions for sell-outs.)

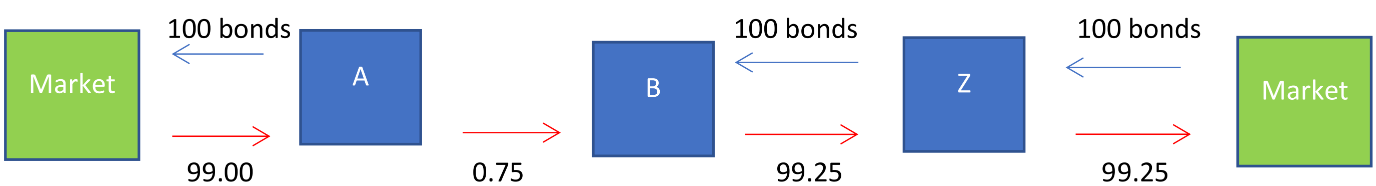
selling/marking their position at the new market price of 99.25,[11], is economically in the same position as if the original trade had settled at 98.50 (99.25-0.75).

<u>The costs arising from a buy-in</u>

A buy-in is not intended to penalise a failing counterparty, nor is it the appropriate legal construct to attempt this. A buy-in is a contractual remedy designed to restore the trading counterparties to the economic position they would have been in had the original transaction settled. However, the failing counterparty being bought-in will invariably suffer some economic cost through the process. This is as a consequence of the buy-in execution price being higher than the market 'fair value' price. The reason for this difference is that a buy-in will be for *guaranteed delivery*, which means that the seller into the buy-in must physically hold the securities and be able to deliver them to the buy-in agent; this invariably commands a premium. Furthermore, a buy-in in itself is a signal to the market that securities will be purchased *no matter what the price*, and so sellers will adjust their offer prices accordingly. As a general rule, the less liquid the security, the greater the *buy-in premium*.

The cost of the buy-in premium to the failing counterparty is illustrated below, drawing on the same example used above.

The cost to the failing counterparty due to the buy-in premium



In this scenario the buy-in is executed at 99.25, compared to a 'fair' market price of 99.00. B is restored to its original position of buying the securities at an equivalent of 98.50 (99.25 – 0.75), however, when A re-sells/marks its position, it incurs a loss of 0.25 (99.00 – 98.50 – 0.75).

It should also be remembered that even where the buy-in execution price is the same as the market price, the counterparty being bought-in will most likely still incur a cost through the bid-ask spread (with the buy-in executed at the 'ask' price, and the bought-in counterparty re-selling/marking their position at 'bid'). Furthermore, the bought-in counterparty may be liable for any fees charged by the buy-in agent (see earlier section).

[11] It is important to understand that after the selling counterparty (A) is bought-in, the original settlement instruction is canceled which restores A to the position they were in before the original transaction. The new position will either need to be flattened (through another sale) or marked-to-market; either of which (after the price differential between the buy-in price and the original transaction price is settled between A and B) will restore A to the economic position they would have been in had the original trade settled.

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