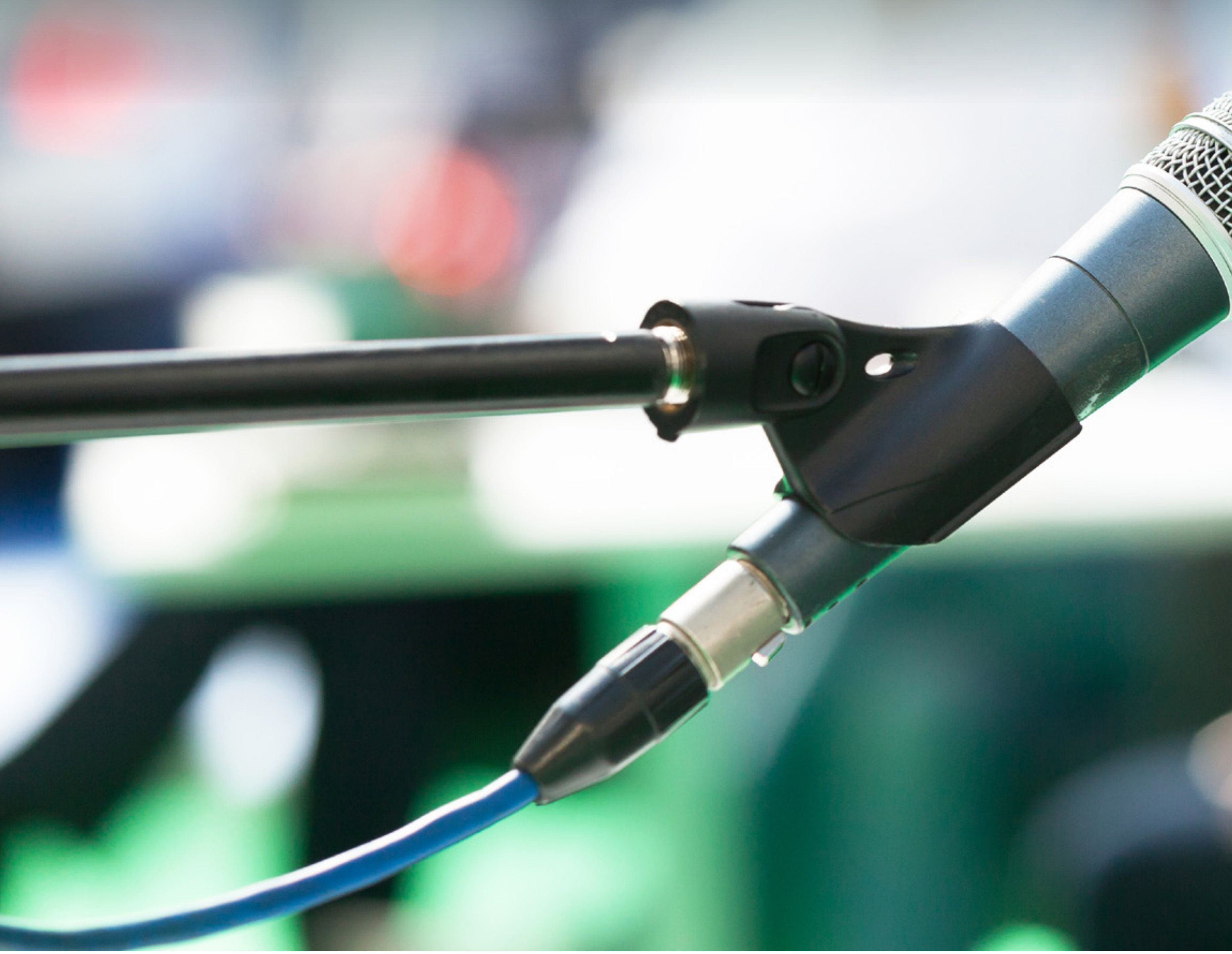
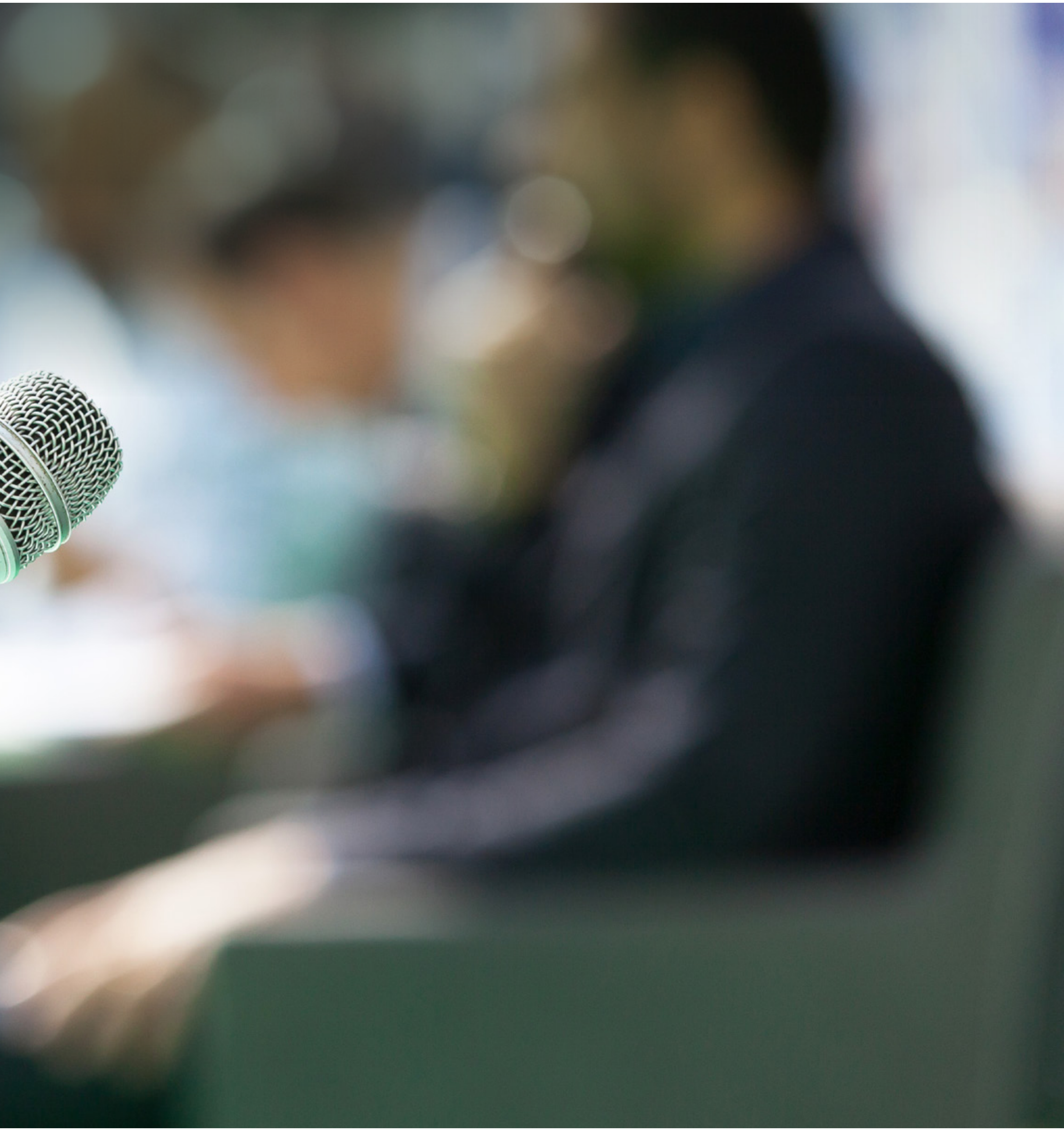
CSDR Virtual Roundtable

CSDR aims to harmonise timing and standards of conduct in the European securities settlement industry. With the settlement discipline measures scheduled to go live on 1 February 2022, industry experts weigh up the impact of this regulation and the market's state of readiness





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How does the settlement discipline regime component of CSDR offer benefits to the market? And where may the SDR component of CSDR have negative implications?

Matthieu de Heering: The Central Securities Depositories Regulation (CSDR) is one of many EU regulations aimed at benefiting consumers, in this case the European investor and pension-holder. Here the focus is on ensuring that the opportunity cost (of positions unavailable for ensuing trading) and the issues created by late settlement are not borne by the individual investor.

However, compliance with CSDR can bring benefits to the entire market and its participants, given the impact that a failed settlement – for instance due to an unavailable position — has up and down the settlement chain. This includes the cost of penalties, the threat of buy-ins, and of related claims, which can amount to billions.

Conversely, decreasing the likelihood of a single settlement failure and the risk of buy-ins, through the application of CSDR and its penalties, can have a positive effect beyond the individual settlement instruction. This will be realised in terms of client experience and available liquidity for the individual investor and the market in which they operate.

In terms of negative implications, we know that the burden created by settlement discipline regimes, such as CSDR, is a primary concern for clients. Buy-in regimes can bring additional operational risk, given that the procedure itself is often manual. This is in addition to the market risk arising from the possible price change of the underlying security, with Murphy's law holding that the price will always shift in the direction that disadvantages the entity obliged to perform the buy-in.

Daniel Carpenter: Of course, reducing overall rates of settlement fails is the 'Holy Grail' for the industry as a whole, so anything that focuses the collective effort around that goal has to be welcomed.

As is so often the case when new regulations are introduced, financial institutions are obliged to review their systems and operational processes. The updates they make can have an additional positive impact on their operational efficiency and effectiveness as a by-product of this review.

We also see a number of other potential benefits to CSDR. First, in the better allocation of resources. Market participants will have a monetised criterion on which to decide the priority of settlement and where to allocate their resources.

> *Compliance with CSDR can bring benefits to the entire market and its participants*
>
> **Matthieu de Heering**

With the threat of penalties, the expectation is that counterparties on all sides will apply greater diligence to settling transactions and the reduction in fail rates will have a positive impact on their bottom lines, as well as leading to better market liquidity.

Second, we should also see greater levels of ownership around prudent inventory management, enhancements to pre-matching and greater scrutiny of standing settlement instruction (SSI) population integrity to mitigate fails.

Better counterparty risk management and the application of sophisticated analytics and artificial intelligence (AI) should also identify those counterparties more likely to fail. With greater transparency of the cost structure, including settlement costs, the front-office will have the information they need to implement more informed trade execution strategies to help mitigate penalty costs and buy-in risk. By accelerating settlement harmonisation and standardisation, the settlement discipline regime could also serve to advance the industry's move to T+1.

One of the main concerns, if the mandatory buy-in rules remain in scope, is the potential for increases in the price of securities and the impact on liquidity. For example, where buy-in obligations apply to illiquid stocks, the costs of buy-ins and cash compensations may become prohibitive as demand out-

Despite the buy-in regime being designed to protect the end-investor, it could create unintended consequences for the investor

Paul Baybutt, director, senior product manager, global middle office product, securities services, markets & securities services, HSBC

CSDR was introduced in 2014 to improve the safety and efficiency of securities settlement and the market infrastructure supporting settlement. Settlement discipline is specifically targeting settlement efficiency with the aim of eliminating settlement fails.

An efficient market, where settlement occurs as intended, has many benefits for participants. Trades failing to settle on time introduce risk and costs for the parties affected. Resources required to deal with exceptions include additional margin and operations staff. Investors failing to receive their securities cannot resell them, which can cause problems when sales are required to raise cash.

The objectives of improving settlement should reduce these costs and make the industry more efficient. Settlement discipline could lead to some unintentional consequences. The European Commission has said it is considering proposing certain amendments to the mandatory buy-ins following its targeted consultation earlier this year.

If mandatory buy-ins go ahead, it has been well documented that there are many challenges to the industry. The regime mandates that a neutral, third-party buy-in agent must be appointed to execute the buy-in. But, to date, only Eurex Securities Transaction Services has said it will offer this service.

Despite the buy-in regime being designed to protect the end-investor, it could create unintended consequences for the investor. Should counterparties include a premium for guaranteed delivery, this would have a distorting effect on pricing and increase the cost of the transaction.

Secondly, buy-ins are not always possible, and an investor buying for long-term returns may find that the remedy for a failed buy-in, in the form of cash compensation, is not preferable.

Lastly, the buy-in process is complex and amendments to settlement discipline may be needed, as the European Commission has acknowledged, to make them more proportionate with the SDR's objectives.

strips supply. From an operational perspective, the workloads will increase for operations teams, incurring more cost unless automated procedures are deployed. The risks of failing to cancel failing trades and holding double stock will also affect market liquidity. These points could prompt some market makers to decide they no longer want to support certain securities, further reducing the liquidity of those assets.

Bill Meenaghan: In contrast to the reaction towards the buy-in regime, the cash penalty regime has been broadly accepted by the industry with most participants now agreeing that it represents a positive move in enhancing settlement discipline within the European securities markets.

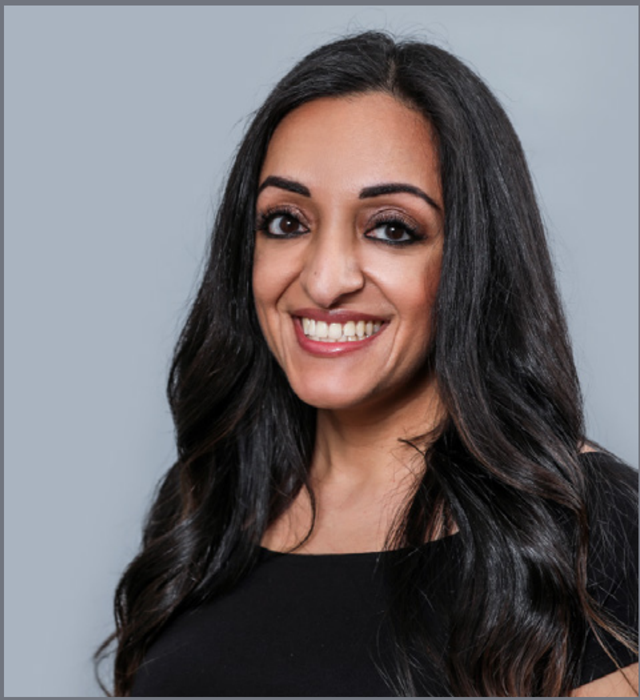
This should promote improved settlement rates as the prospect of a penalty for settlement failure drives market participants to ensure settlement finality. However, not all markets in Europe impose penalties today. In some cases it can be cheaper (or free) to fail a transaction, rather than recall a security early from securities lending. For very efficient participants, SDR may even prove to be an income stream if counterparties fail to deliver. On the negative side, liquidity may dry up in some cases. A lot of brokers do not hold inventory, instead taking on the deal with the expectation that they should be able to source the security. For less liquid securities, this may not happen as easily. The broker will know that if they fail to source the delivery, they may have to pay the SDR penalties and any commission they would have gained can be quickly lost — although this would be offset by penalties received from their counterparty. This could slow down how quickly orders get filled and confirmed in the markets.

There could be an impact on securities lending as well. Any delay in getting securities back from loan could result in an SDR penalty, which may result in less securities lending. This could disproportionately impact less-liquid securities, as participants may be less willing to trade them.

There are also no agreed de minimis rules on claim amounts, so another negative impact will be the amount of claims that are likely to be issued and received. Very small amounts may be ignored and swallowed by some of the participants, but there could be claims for amounts that are below the current ISITC threshold of $500 equivalent.

The numbers of these claims are likely to be high, so participants could see lots of these coming through next year.

Pardeep Cassells, head of financial products, AccessFintech



The important thing to remember is that, despite the complexity of the regulation and the challenges that organisations seem to be facing, the settlement discipline regime is intended to benefit the market.

A clearer focus on pre-matching will naturally lead to improved confirmation of trades and reduce fail rates.The intended penalty and buy-in regimes will help those organisations who consistently find themselves impacted by failed deliveries off-set the cost of managing the failed and mismatched trades.

It is vital that we bear in mind the current cost of managing fails at their current rate across the market. Banks and buy sides have entire operational functions in place purely to manage the inefficiencies of failed trades and mismatched trades. This impact is compounded for smaller firms that are not prioritised for deliveries and that would benefit from a structured and mandatory buy-in process.

In February 2020, the 'Joint Associations' said CSDR may remove incentives to lend securities in securities lending and repo markets, and it may lead to wider bid-offer spreads in the cash markets.

This may encourage market participants to move settlement of less liquid securities into non-EU CSDs that are not subject to CSDR. Do you agree? How real are these concerns?

> *Any increase in trading and settlement activity outside of CSDR jurisdictions would be like kicking the can down the road*
>
> **Daniel Carpenter**

Carpenter: While the threat of buy-ins may prove to be an incentive to borrow securities, illiquid assets will always be more difficult to borrow and there is not a specific solution to solve this. We believe that forecasting and predictive analysis will play a key role in risk mitigation here.

When it comes to collateral management, the most commonly used securities are bonds, particularly sovereign-issued bonds, which are traded less actively than some other securities. With the European Central Bank set to accept as collateral a wide array of security types, the impact should be minimal in the event that trading in equities slows down. However, any increase in bond market liquidity could drive up prices for these bonds for buy-side firms.

Any increase in trading and settlement activity outside of CSDR jurisdictions would be like kicking the can down the road. With CSDR set to apply to any security issued within the EU, whether or not it is ultimately settled outside of the EU, it remains to be seen whether the impact of CSDR will outweigh the benefits of moving stock listings to another jurisdiction.

Bill Meenaghan, director, product management, IHS Markit

The International Securities Lending Association (ISLA) warned that the mandatory buy-ins for settlement fails may discourage asset owners from lending, adversely affecting the global liquidity pool. However, many securities are now multi-listed and held in one of several depositories. While CSDR may force some issuers to consider where they list their securities initially, it may encourage others to add a multi-listing to a non-CSDR central security depository (CSD).

Participants could decide that assets should be inventoried in non-CSDR CSDs in these cases, but we do not think we will see a large movement of issuance to non-CSDR CSDs purely to avoid the SDR penalties, given the securities access provided within EU central securities depositories. Multi-listed securities are often cited as causing issues amongst participants, so it is unlikely that participants will be willing to add to this problem given the small chance of a fail on any one security.

When ICMA, one of the signatories to the letter, conducted an impact assessment across its membership, 100% of sell-side firms and 80% of buy-side respondents said that the introduction of mandatory buy-ins would have a negative effect on overall market efficiency and liquidity. ICMA members predicted that traditional lenders in securities lending markets are likely to "hold more buffers, or even withdraw inventory", which would limit loan availability to cover short positions. Do you agree?

> *"Mandatory buy-ins may be a step too far and too soon for the industry"*
>
> **Bill Meenaghan**

Meenaghan: The International Capital Markets Association (ICMA) called for the mandatory buy-in aspect of SDR to be scrapped, stating that the mandatory buy-in regime would have adverse impacts on European bond market efficiency and liquidity, leading to increased costs for market participants and, specifically, the end investors.

Mandatory buy-ins may be a step too far and too soon for the industry. As the Association for Financial Markets in Europe (AFME) suggested, the buy-in should be a discretionary right of the receiving party, not a mandatory obligation, describing it as a "disproportionate measure to address settlement fails". For some illiquid securities, it is not possible to source them in advance of the buy-in. If the asset manager wanted exposure to that security and was willing to wait, the current rules would prevent that since the asset manager is mandated to buy-in after 10 days if the security is illiquid.

Participants would need to keep strict reporting in place to monitor how much can be lent in these cases — and they may limit the percentage that they lend, or even withdraw from the security lending markets, if penalties are levied on their assets. While the penalties may be covered by the lenders in some cases, we would expect to see a reduction in available inventory as a direct result of mandatory buy-ins.

Daniel Carpenter, head of regulation, Meritsoft (a Cognizant company)

Market making in illiquid assets will undoubtedly be less appealing as the cost of buy-ins, and possibly cash compensations, will reduce the expected returns. When it comes to liquid assets, where several parties buy-in the same securities, the increase in demand will reduce liquidity in those securities and have an impact on their pricing. Furthermore, if a firm is in a back-to-back and buy-ins are mandatory, both the firm and the counterparty they sell to might execute a buy-in. If that happens, then the firm will have bought securities that they cannot deliver anymore as their underlying sale will be put on hold and eventually cancelled. In that case, they will increase their inventory and incur the associated costs.

ESMA's recommendation to postpone the CSDR component to February 2022 was originally linked particularly to concerns over the readiness of the market infrastructure to accommodate SDR changes – for example, in the need for testing of the new penalty mechanism within the T2S environment. In the meantime, we have had COVID-19. Is the market infrastructure now ready for the settlement discipline and buy-in regime under CSDR?

Cassells: Given the recent announcement from the European Commission conceding that there is still a lack of clarity around, and support for, certain elements of the regulation, it would be impossible to say that the market infrastructure is now fully ready for CSDR.

With multiple questions still outstanding in relation to eligibility, and with only one buy-in agent confirmed in the face of a regulation that insists that conflict be avoided in the appointment of agents, there is much to be done. The majority of CSDs are still to confirm how they will interact, publish and consume information through the lifecycle.

AccessFintech's Implementation Working Group has taken huge strides to push the market forward, specifically by defining market best practice data standards and messaging formats for CSDR, and this pragmatic collaboration is key given the February 2022 deadline is still in place.

Meenaghan: The market has had many years to get ready for the SDR regime, but still feels unready for the introduction in February 2022. However, applying the penalty regime is more straightforward, with fewer grey areas, and participants have been able to make progress on their agenda to support the regime.

With the new cash penalty regime due to come into force on 1 February 2022, participants should now be close to completing their preparation. With analysis and development now largely done, implementation should be underway.

However, there is a strong feeling in the industry that buy-ins should be delayed, or the need for them to be mandatory should be removed. Only one entity has stated they will act as a buy-in agent and they will require collateral to facilitate it. That will be a complicated and expensive way to manage it if no other buy-in agent steps forward.

Baybutt: The market infrastructure is not yet ready and SDR is currently under review.

While there is the European Central Securities Depositories Association (ECSDA) CSDR Penalties Framework that the industry is able to work to, the buy-in regime is a different matter and the market awaits the outcome of possible amendments before its implementation.

Carpenter: Based on our engagement with the industry over the last two years, we know that projects have been proceeding in the majority of houses. With a degree of uncertainty remaining over whether buy-ins will be mandatory or voluntary, or their inclusion in the rules delayed, the focus has naturally been on preparing for penalty processing and many have this well in hand.

Those CSDs using TARGET2-Securities (T2S) to record their positions and settle their participants' transactions have collectively agreed with the European Central Bank that the platform will form part of the solution.

T2S will support the CSDs in their CSDR obligations by calculating the penalties for all in-scope securities and reporting them to the CSDs who will, in turn, process them and distribute them to their own participants.

The CSDs stay in control of their participant relationships and are accountable for their obligations. The Directly Connected Parties (DCPs) will receive their own reports from T2S.

However, there are still questions about what happens to those assets CSDs hold outside of the T2S platform which are in scope for CSDR, and how these will be reconciled under the new regime. In addition, with T2S calculating penalties on each of its settlement days, irrespective of local variations in individual CSD operating days, how will they address the penalties that are calculated on those additional dates — and their removal after the fact?

More specifically, our clients have been putting systems and processes in place to meet both the penalties and buy-in requirements, and to accommodate their impact on securities lending processes, with the flexibility to adapt whatever shape those rules ultimately take.

The potential impact of the mandatory buy-in regime is complicated by the fact that the settlement process often involves a complex network of interlinked transactions – where a settlement failure can lead to failure across a whole chain of settlement instructions.

What problems does this present to market participants in modelling this process, particularly in securities lending transactions? What about tracking the movement of penalties along the chain of transactions and identifying how these will be allocated to the relevant parties?

Baybutt: In our role as an outsourcing provider to the buy-side, we are generally at the end of the chain. Therefore, the impact of any settlement failure along the chain will ultimately lead to our clients failing to receive securities. The counterparties our clients trade with may source securities from multiple places, pooling the sources to fulfil a delivery. If one of the sources fails to settle, the whole delivery to our client will fail. The introduction of partial settlement is welcome to reduce settlement exposure and increase settlement efficiency. This, in turn, should reduce the volume of penalties across the chain.

Carpenter: Oversight and transparency of settlement and buy-in statuses is the foremost issue. As with all aspects of our industry, there is a plethora of in-house, market and vendor solutions that will need to inter-communicate to provide holistic oversight of these in-scope items. Transparency and integration are key components of our technology solution. The ability to normalise vast amounts of transaction and other relevant data and provide a single, centralised view is vital.

Enabling collaboration and communication between counterparties through the number of different mediums currently in play is also essential to ensure a common understanding of status between counterparties. To help the industry by leveraging our platform and application programming interfaces (APIs), we have created real-time messaging integration enabling users to stay in the solution but coordinate with outside agencies to address these points.

Meenaghan: Securities often move in a connected chain of transactions. Client A buys from Client B who bought from Client C. If Client C fails to deliver, then Client B cannot deliver to Client A. Client A would be due penalties from Client B, who would in turn be due penalties from Client C. For Client B, this should be a wash as the depository sets the reference price on a daily basis for the penalty, so as long as these are all in the same CSD, then Client B would have an equal debit and credit and the right entity, Client C in this case, would be the penalty payer.

> *The introduction of partial settlement is welcome to reduce settlement exposure and increase settlement efficiency*
>
> **Paul Baybutt**

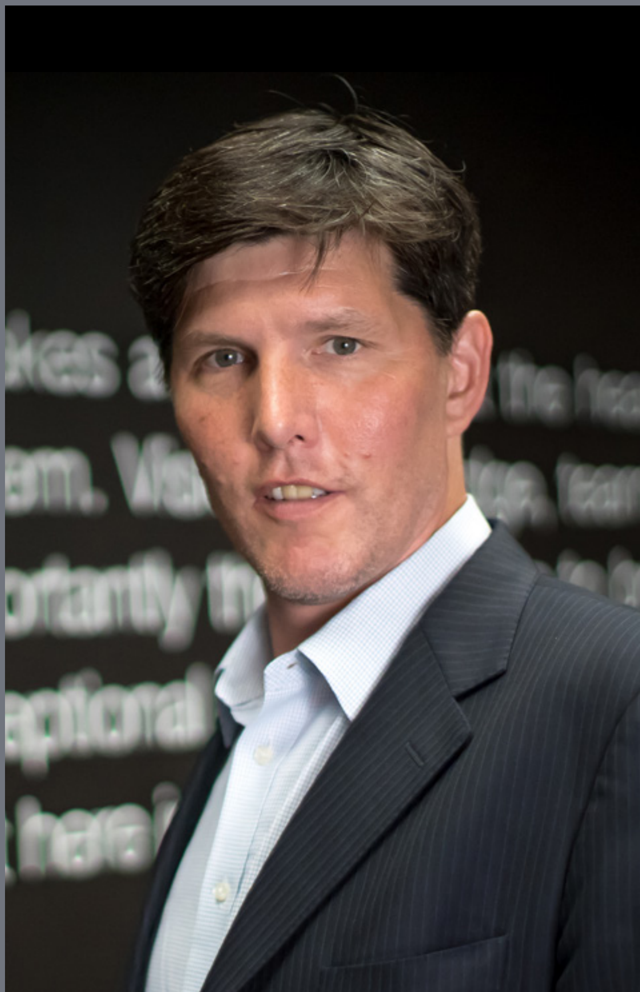
There could be an issue, though, if there was a different CSD involved in the chain as they may set a different reference price from the original CSD. It would be necessary to monitor this to ensure that you are not paying a penalty on a failed trade that was not your fault. If the delay was because Client C had the security on loan, that also brings more entities into the mix as the securities lending agent would have lent that to a fourth client. Consequently, analysis will be needed to identify who ultimately caused the delay.

Cassells: As a data-focused provider supporting the entire transaction lifecycle by aggregating trade data from across the market into a single infrastructure, we can see first-hand how operationally challenging the identification and tracking of chains will be.

We have introduced functionality to support this linkage and connectivity to create a foundation for the identification of chains. However, this is definitely an area where we will all learn more as time goes on.

SWIFT has worked with industry groups, including SMPG and AFME, to bring ISO 15022 and ISO 20022 messages in line with CSDR requirements

Matthieu de Heering, director, capital markets strategy, SWIFT



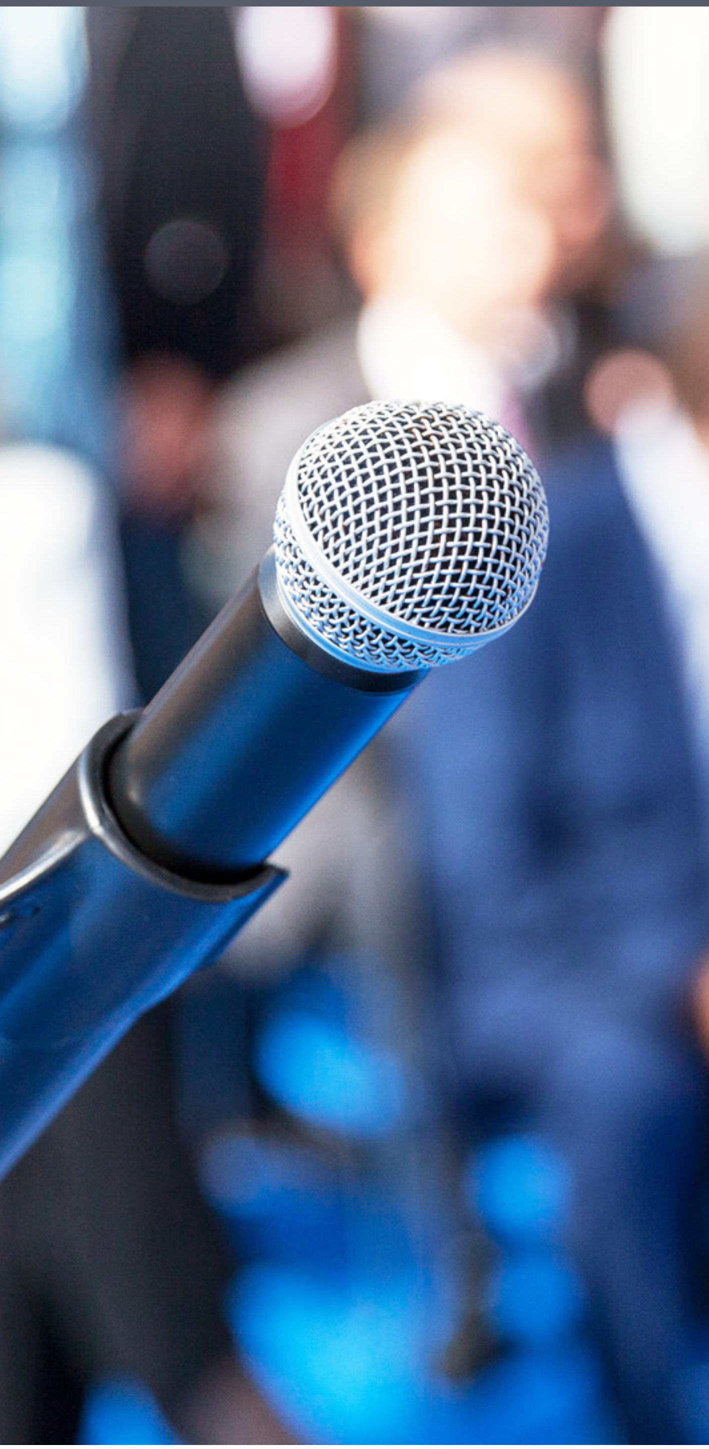
Complying with CSDR is a key focus area for clients. We also expect copy-cat settlement discipline regimes to come up in other markets. Mandatory buy-ins already pre-date CSDR in some European countries. We believe the solution comes through end-to-end tracking of transactions as they progress through their lifecycle. SWIFT's solution is based on a Unique Transaction Identifier (UTI – ISO 23897:2020).

This forms part of SWIFT's move to transaction management, which is core to our platform strategy. The platform will maintain a copy of the transaction data that post trade service providers can tap into to enrich services. In working with early adopters, we established that the UTI is the right unique ID to apply — across messages and in the future APIs — to transactions on the SWIFT network.

Moreover, with our enhanced platform and end-to-end transaction monitoring data, all parties to a transaction will be able to gain early visibility on the content of settlement instructions and the latest processing status. This will also enable market participants to benefit from the enrichment or validation of standard settlement instructions, which can be a source of operational failures.

SWIFT has also worked with industry groups, including the Securities Market Practice Group (SMPG) and AFME, to bring ISO 15022 and ISO 20022 messages in line with CSDR requirements. Updated messages have been live on the SWIFT network since November 2020. We will also make available new ISO 20022 messages relating to T2S penalties reporting under CSDR.

UK policymakers have taken a decision not to implement the settlement discipline regime inherent in the EU CSDR regulation. What will be the primary implications for the UK market and for market participants with trading and settlement activities across these locations?



Meenaghan: Dual-listed securities that can be held in the UK and a CSDR CSD may be inventoried in CREST rather than another CSD, and trading activity may start to shift to CREST. The UK market is the biggest in Europe and currently has an existing fines process for late settlement.

While the fines are relatively small, they do exist. Without SDR, the rest of Europe could become more efficient than the UK market. However, the UK government has announced that it will consider a penalty mechanism in due course if there isn't an improvement in the UK settlement efficiency rate and this starts to become a problem.

Baybutt: While parties trading and settling securities in the UK will not have to implement the settlement discipline, many of those parties, however, also trade securities settling in CSDR-eligible CSDs.

That means they will still have to implement settlement discipline for securities they trade and settle in Europe.

What is not clear at the moment is whether this decision will make it attractive to issuers to issue securities into the UK CSD rather than a European one. Clearly there would be benefits, but settlement is not the only driver that an issuer considers before choosing its CSD. Until the outcome of the European Commission's impact analysis is concluded, and possible amendments proposed to settlement discipline, the implications will not be clear.

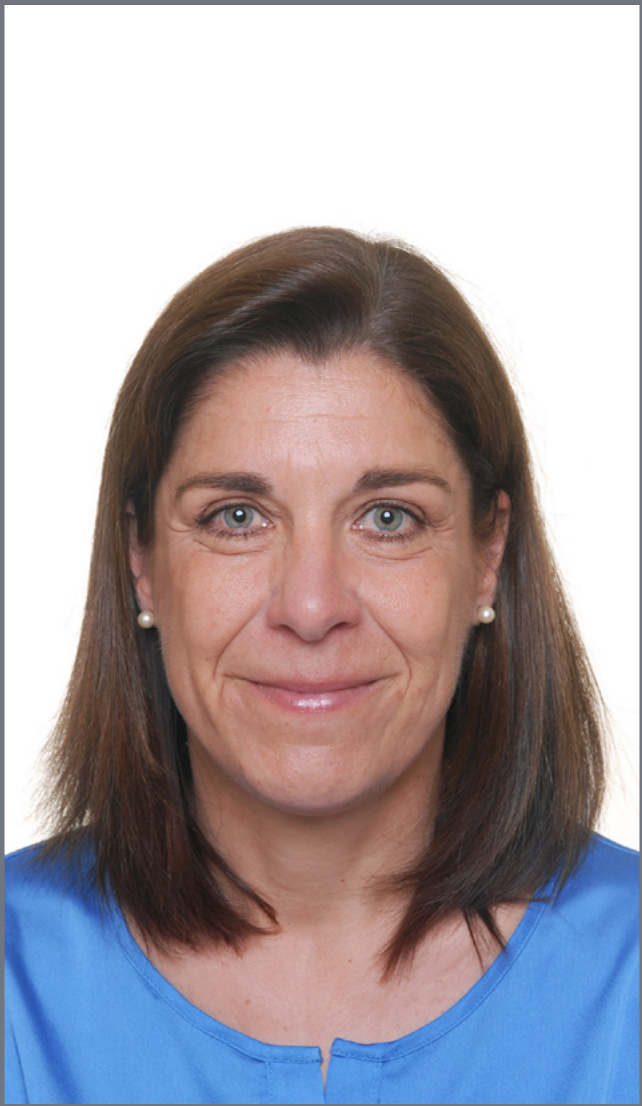
Carpenter: Like so many regulations that apply across capital markets, CSDR and SDR rules have extra-territorial impacts.

While existing practices will stay as they are for the UK domestic market, any firm that trades in securities listed in the EU, the European Economic Area (EEA) and Switzerland will have to comply fully with these new rules.

Fundamentally, the more divergent country rules are, the more complex operations processing becomes and the greater the need for flexible and comprehensive rules-based automation solutions to manage these complexities effectively and to help ensure regulatory compliance.

The securities monitoring service within SWIFT's enhanced platform will be available to SWIFT's global securities community, irrespective of national market implementation of settlement discipline regimes

Karin De Ridder, head of standards development team, SWIFT



The securities monitoring service within SWIFT's enhanced platform will be available to SWIFT's global securities community, irrespective of national market implementation of settlement discipline regimes. With markets so interconnected, the extraterritorial impact of CSDR on non-EU financial institutions is such that we have strong buy-in globally. Furthermore, with standards widely used in securities settlement, reconciliation, custody and corporate actions operations, and the post-trade domain, it is fundamental to ensure straight through processing (STP) is supported. The annual standards release cycle for ISO 15022 and ISO 20022 messages on the SWIFT network has contributed year after year to rising STP rates.

Increased regulation, including CSDR and, more specifically, the new settlement discipline regime, has also triggered changes to widely used securities messages supporting compliance.

CSDR requires that CSDs must implement a penalty mechanism for late or settlement failures, with penalties calculated and reported on a daily basis. To support this, SWIFT Standards added a new penalties reporting block to the MT 537 Statement of Pending Transactions, and the MT 548, Settlement Status and Processing Advice, and their ISO 20022 equivalents.

CSDR also imposes a buy-in mechanism in cases where the delivery of securities fails. Since the new order for the buy-in must carry a reference to the original trade, SWIFT Standards has harmonised the buy-in indicators in the ISO 15022 Trade Initiation and Confirmation messages. In addition we adapted MT 530 – Transaction Processing Command – so that required buy-in and cash compensation information for failing trades can also be communicated to and from the CSDs.

Provisions already existed in a number of EU markets which applied settlement penalties to counterparties that caused transactions to fail, enabling counterparties (or the CCP) to initiate a buy-in. So are the settlement discipline provisions of CSDR necessary? Or was preceding regulation sufficient?

> *We have seen great collaboration as organisations have come together to solve for the requirements of the settlement discipline regime*
>
> **Pardeep Cassells**

Cassells: The typical average timely settlement rate on the market is around 95 per cent across equities and fixed income, and the intent of the settlement discipline regime is to close that 5 per cent gap.

Although provision for voluntary buy-in exists, this is little exercised at the moment and penalty regimes are inconsistent. To achieve consistency, close the 5 per cent and ensure consistent timely settlement, something does have to change.

We have seen great collaboration in the last 12-24 months as organisations have come together to solve for the requirements of the settlement discipline regime. If this collaboration could translate into an effort to identify and eradicate the thematic cause of fails, then the provisions may not be necessary.

Ultimately, that is exactly what is being targeted. Rather than focus on the punitive measures being introduced, organisations should look to rise to the challenge by reducing fails, increasing matching accuracy and, in doing so, minimising the impact of the settlement discipline regime.

Baybutt: A number of EU markets currently use penalties for late settlement. However, these are often designed to cover the cost of exception processing caused by late settlement, rather than designed as an incentive for settlement.

Settlement discipline is intended to make settlement even more efficient. According to a recent analysis by the Target2Securites CSD Steering Group, the settlement efficiency rate of the market under CSDR in both equities and fixed income does not exceed 90 per cent. It is also important that settlement discipline is proportionate to the costs and administrative burden necessary to implement it.

Indeed, the Commission has said that in light of the latest consultation it will consider proposing amendments to the mandatory buy-in rules to make them more proportionate and to avoid undesired consequences.

Carpenter: Under previous regulation, there was no real consistency or best practice. Each market built its own rules organically and from a domestic point of view. The rules were similar across markets, but where they diverged they presented some challenges for counterparties trading and settling across markets. Additionally these are optional rules, making their application somewhat difficult for houses to apply or impose for risk of loss of business.

The fact that the majority of EU CSDs now settle on T2S has brought that issue to the forefront. The stated aim of T2S is to simplify and promote cross-border settlement, allowing participants in different CSDs to settle with one another seamlessly. This requires consistency in penalty rates, timeframes and buy-in processes across CSDs.

Meenaghan: The T2S annual report shows that the threat of SDR has not made a difference to settlement efficiency rates yet. In 2019, 96.93 per cent of trades were settled on the expected settlement date in T2S. However, for 2020, this dropped to 94.51 per cent, a 2.5 per cent drop. This is a very significant negative change given the market would have expected participants to become more efficient at settling trades on time, given SDR was originally scheduled to go live in September 2020. Preceding regulations have not so far made the difference that was anticipated. Buy-ins, though, may be a step too far, as these may cause unintended consequences for the industry.