

CSDR Mandatory Buy-ins and the treatment of SFTs
An ICMA-ERC Briefing Note
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Background

The regulation on central securities depositories and securities settlement (otherwise known as CSDR) establishes a framework designed to enhance settlement discipline (Article 7), including the provision for penalties for settlement fails and a mechanism for executing mandatory buy-ins against failing transactions in financial securities. The text provides that buy-ins should be initiated in the event of a transaction failing for 4 business days (the 'extension period'), with the scope for this to be increased up to 7 business days *'where a shorter extension period would affect the smooth and orderly functioning of the financial markets concerned'*.

Existing remedies for failing SFTs

Both the Global Master Repurchase Agreement (GMRA) and the Global Master Securities Lending Agreement (GMSLA) provide for remedies in the case of a failing repo or securities lending transaction, and are broadly similar in their approach. Under these contracts, in the case of a failing SFT, the disappointed counterparty has the option of either declaring a 'default event' (which would terminate the entire trading relationship between the parties), or they can elect to issue a 'mini-close-out' which applies only to the failing transaction. In the case of a failing start-leg of a SFT, this is equivalent to closing out the transaction and claiming any interest that would have accrued to date had the trade settled. In the case of a failing end-leg, this also terminates the SFT, but allows the disappointed counterparty to claim for any incurred cost in replacing the underlying security, which is effectively similar to a buy-in.

The reason for the different treatments for start and end-legs is quite deliberate. Given the economics of lending securities compared to the significant and unpredictable costs of being bought-in, a buy-in mechanism for failing stock loans or repos would deter lending of securities, and so be counterproductive. Furthermore, it can be sensibly argued that a buy-in would be the wrong remedy, since it would replace a loan of a security with an outright purchase. Meanwhile, a buy-in like provision for a failing end-leg provides lenders with protection in the event that their securities are not returned at the end of the SFT.

SFTs and secondary market liquidity

SFTs play a critical role in supporting secondary market liquidity. Market-makers in government and corporate bonds, as well as equities, rely on SFTs to be able to show offers in securities to investors. The ability to reverse or borrow a security allows them to settle any short-sales until they are able to cover the position. However, where a failing SFT causes a cash sale to fail, this will not protect the market-maker from buy-in risk, since the cash fail can be bought-in, but this cost cannot be passed on to the failing lender of the security. However, given the relative infrequency of buy-ins in the outright cash markets, the risk is perceived to be relatively small. Also, the fact that lenders of securities cannot be

bought-in ensures liquid SFT markets, which in turn improves settlement efficiency and reduces the risks to the market-maker. Effectively, discretionary buy-ins for cash markets, and the inability to buy-in the start-leg of an SFT helps support a virtuous circle for secondary-market liquidity.

Under a mandatory buy-in regime, this virtuous circle will be reversed. Market-makers will be more exposed to buy-in risk from failing sales, but will be unable to pass this on if the start-legs of SFTs remain exempt. However, if the start-legs of SFTs also become subject to mandatory buy-ins, this will deter lending, further reducing the ability of market-makers to offer securities. Neither scenario is perfect and in both cases the result will be to deter market-makers from offering securities they do not already hold, reducing secondary-market liquidity and widening bid-ask spreads. Thus the costs of increased buy-in risk will be borne by issuers and investors.

Collateral fluidity

Repo and securities lending markets are also the mechanisms by which collateral is mobilized through the financial system, and which is essential for collateralizing loans, meeting liquidity ratios, and margining derivatives transactions. As discussed, mandatory buy-ins for SFTs will deter lending and so impact the available supply and fluidity of high quality liquid assets.

CSDR mandatory buy-ins and SFTs

Article 7(4)(b) of the CSDR Level 1 text proposes an exemption for short-dated SFTs from the practical perspective that *'the timeframe of these operations is sufficiently short and renders the buy-in ineffective'*. Also, it is not clear whether the exemption would also apply to the failing end-leg of such a short-dated trade (although, from a practical perspective, it is difficult to see why there would be an exemption for the end-leg of a SFT for any term).

As discussed, in a mandatory buy-in world, both exempting and excluding SFTs are imperfect scenarios that will negatively impact secondary-market liquidity and collateral fluidity. However, the proposed partial exemption for SFTs produces even more problems, not least in creating a bifurcated market for SFTs between exempt and non-exempt SFTs with very different demand and supply skews. If some SFTs are exempt from mandatory buy-ins and some are not, this creates the potential for a two-tier market in SFTs, with the associated fragmentation and loss of liquidity. It also makes managing buy-in risk difficult.

For example, from the perspective of a market-maker who is short-selling securities, they will want to hedge their buy-in exposure by only covering with non-exempt term SFTs. Meanwhile, lenders of securities will want to avoid the potential for being bought-in on a failing start-leg, and so will only want to lend securities for short-dates (i.e. exempt SFTs). This two-tiering becomes even more complicated for repo and financing desks that will be making markets in, and managing the risk related to, both exempt and non-exempt SFTs.

This will also present problems in terms of executing buy-ins at the CSD level. Currently the vast majority of CSDs are unable to distinguish between outright cash trades and SFTs. To successfully manage the proposed treatment for SFTs, not only would they need to be able to identify SFTs, but they would also need to be able to identify whether it is the start-leg or the end-leg, as well as the term of the SFT (exempt or non-exempt).

Then there will be issues for CCPs who will have to create separate pools for netting for both exempt and non-exempt SFTs. In turn, this will have adverse netting implications for CCP counterparties.

The ICMA - ERC position on mandatory buy-ins and SFTs

Mandatory buy-ins are likely to be counterproductive to the objective of settlement efficiency and will have negative impacts for secondary market liquidity and spreads, which will be a cost ultimately borne by issuers and investors.

In as much as mandatory buy-ins impact SFTs, this will have further negative implications for both secondary market liquidity and collateral fluidity. Partial exemption will compound these issues, creating a bifurcated SFT market with different demand and supply skews, as well as adding additional complexities to risk management. The least damaging interpretation of Article 7(4)(b) would be to exempt the start-legs of most SFTs, and to consider term-SFTs, at least out to 6 months, as 'sufficiently short'.

In the meantime, there is a lot that can be done to improve settlement efficiency before introducing mandatory buy-ins. Initiatives such as Target-2-Securities, and improvements in the ICSD 'bridge', should be successful in reducing the incidence of failed trades. Improving and standardizing procedures for trade confirmation and affirmation will support settlement efficiency. An efficient and well calibrated mechanism for cash penalties and compensation for fails should also encourage the timely settlement of trades.

SFT scenario-analysis for mandatory buy-ins

Scenario for SFT treatment	Implementation Pros	Implementation Cons
Current market structure	<ul style="list-style-type: none"> • Can still buy-in against a failing end-leg • Can include end-legs in unravelling fail-chains • Can initiate at discretion, so no timing mismatch issues • Encourages lending, since no buy-in risk for failed settlement while protecting against failed returns 	<ul style="list-style-type: none"> • Cannot buy-in against a failing start-leg, thus 'breaking' fails-chains • Necessary to differentiate between SFTs and outright, and between start and end-legs
No exemption	<ul style="list-style-type: none"> • Can include both start and end-legs in unravelling fail-chains • No need to differentiate between SFTs/outright, start-legs or end-legs, or term of SFT 	<ul style="list-style-type: none"> • Will discourage lending since lenders exposed to buy-in risk • Oddity of executing and settling buy-ins after many trades have matured
Partial exemption (as per CSDR Level 1)		<ul style="list-style-type: none"> • Will split SFT market into 'exempt' and 'non-exempt', based on term, with related liquidity and risk-management issues • Will discourage lending for term since lenders exposed to buy-in risk • Some SFTs will break fails-chains, others will not • Necessary to differentiate between: SFTs and outright; start and end-legs; and term of SFT • Repo desks will face greater buy-in risk in the matched-book • CCPs may need to differentiate between exempt and non-exempt SFTs for different netting treatments