# ESMA'S QUESTION & ANSWER (Q&A) TOOL

## *QUESTION SUBMISSION FORM*

| IDENTIFICATION |
|---|
| *1. Name of entity* |
| **International Capital Market Association** |
| *2. Country of incorporation / Residence* |
| Other - please specify below |
| Switzerland |
| *3. E-mail address / Other contact details* |
| **andy.hill@icmagroup.org** |
| *4. Sector* |
| Other |
| **LEGISLATIVE REFERENCE** |
| *5. Level 1* |
| Central Securities Depositories Regulation (CSDR) Regulation (EU) No 909/2014 |
| *6. Article/s of Level 1 Legislative Act* |
| **Articles 7** |
| *7. Other relevant Act/s or Guidance* |
| **Section 3 of Commission Delegated Regulation supplementing Regulation (EU) No 909/2014 with regard to regulatory technical standards on settlement discipline** |
| **QUESTION** |
| *8. Subject matter* |
| **Executing buy-ins against securities financing transactions** |
| *9. Question* |
| **Legal contracts governing repurchase agreements and securities lending agreements generally do not provide for the possibility of executing cash market buy-ins against securities financing transactions (SFTs). Documented SFTs (such as those executed under GMRAs or GMSLAs) have their own contractual provisions in the event of a settlement fail, which are more suited to the nature and risks of the associated transactions. Can these contractual provisions still be used by the relevant parties to an SFT during the extension period?** |

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| *10.* | *Proposed answer* |
| | **Yes. In the case of documented SFTs, it is recommended that the provisions of the applicable contractual framework governing the transaction be applied by the non-failing party by the end of the relevant extension period in order to avoid triggering the buy-in process.**<br><br>**In the case that such provisions are applied by the end of the extension period, a buy-in will no longer be mandatory.** |
| *11.* | *Relevant background* |
| | Existing remedies for failing SFTs<br><br>Master agreements governing repurchase transactions and securities lending transactions (such as GMRAs and GMSLAs) generally do not provide specifically for the possibility of executing a buy-in or cash compensation against the failing start-leg of an SFT. Rather, they generally provide the non-failing party with contractual remedies that have been designed to suit the nature and associated risks of the underlying transaction.<br><br>Accordingly, provisions to ensure settlement discipline are already imbedded in the legal framework governing documented SFTs.<br><br>In the case of a failing start-leg, the non-failing party may have the right to deem this as an event of default by the failing party (thereby terminating all transactions with the defaulting party under the relevant master agreement). This is not standard market practice. Alternatively (and more relevantly), they also have the right to issue a 'mini close-out', which provides for the early termination of the transaction. Any accrued repo interest owed to the non-failing party will be payable by the failing party up to the termination date.<br><br>In the case of a failing end-leg, the non-failing party may again have the right to call their counterparty into default, but also the right to apply a mini close-out. The latter option in this instance provides for the non-failing party to terminate the trade and claim the failing party for the replacement costs of the undelivered collateral (subject to terms specified in the contract).<br><br>In the case of mini close-outs for both start- and end-legs, the effective termination date (and so the end of the fail) is immediate upon notification by the non-failing party. |

Challenges of applying buy-ins to SFTs

Allowing for the execution of a buy-in against an SFT creates a number of logistical challenges as well as risk management considerations for both the failing and non-failing party.

From the perspective of executing buy-ins against start-legs, it is not clear what will need to be done with the original trade. In the case of an outright transaction, this is canceled, but in the case of an SFT only the start-leg instructions would be canceled, with the end-leg instructions remaining intact. However, this becomes even more complicated in the event that the buy-in is not possible and results in cash compensation. In this case, what happens to the original end-leg instructions?

SFTs are often based on multiple or even a basket of substitutable securities. In the case of a buy-in it is not clear what exactly the non-failing party is expected to buy-in, and whether they are required to attempt to buy-in every individual security underlying the trade. This would hardly be to the benefit of either the non-failing party or overall market efficiency.

Applying buy-ins against SFTs also creates significant risks for lenders of securities. The difference between the buy-in price and the price at which the defaulting party sells their bonds will almost always result in a loss for the defaulting party (the 'buy-in premium'). Overlooking the potential impacts of the potential CSDR asymmetry for now, the additional risk and potential costs of being bought-in on an SFT, compared to any potential returns from the SFT, would seem highly incommensurate. This is something that lenders of securities will need to reflect upon before agreeing to lend securities for 30 business days or more, and could result in a shortening in the length of SFT maturities, as well as a more general reluctance to lend securities.

Contractual re-papering

Once the market has clarification that it can still apply contractual remedies in the case of an in-scope SFT, it is likely that the market will need to undertake a re-papering exercise in respect of existing SFT documentation. This may take the form of a new annex to existing contracts that will automatically trigger early termination or mini close-out provisions by the end of the relevant extension period in the event of a settlement fail for in-scope SFTs.

Regulatory guidance that SFT contractual provisions should be applied by the end of the extension period would help to preserve the efficient functioning, stability, and liquidity of the repo and securities lending markets, which would otherwise be compromised by a buy-in framework that is ill-suited to SFTs.



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