International
Capital
Market
Association

ICMA CSDR-Settlement Discipline Working Group

Applying CSDR mandatory buy-ins to SFTs

Meeting note from January 23 2019

Participating firms: *BAML, Barclays, BBH, BGC Partners, BNP Paribas, BNY Mellon, Citi, Credit Suisse, Danske Bank, Deutsche Bank, Goldman Sachs, HSBC, Intesa San Paolo, LCH, Lloyds Bank, MUFG, Nomura, Northern Trust, JP Morgan, RBC, SocGen, Standard Chartered, UBS, Unicredit*
Participating associations: *AFME, EDMA Europe (represented by MTS), ISLA*

Meeting objectives

The meeting was intended to discuss three specific requests to ESMA for Level 3 guidance with respect to the application of CSDR mandatory buy-ins to securities financing transactions (SFTs):

- Treatment of open trades
- Calculating the buy-in/cash compensation difference payment
- Best practice for buying-in failing SFT start-legs

The goal is to finalize formal 'Q&A' submissions, with broad industry support (in particular that of the ERCC and ISLA) that can be taken to ESMA for their consideration to include in Level 3 guidance.

In the meeting, based on the three drafted submissions, members were asked to consider:

- *Do they agree conceptually with the proposed answer?*
- *Are all the key arguments covered in the submission, or can they be enhanced?*
- *What should be the next steps to finalize the submission?*

1) Open trades

- The Group was in agreement that open trades should not be in scope of mandatory buy-ins, with nobody suggesting that they should be. In most cases these trades can be closed by either party with as little as one or two days' notice (well within the 30 business day cut-off). It was pointed out that if ESMA were to opine that open trades were in scope, then the market would simply shift to 'weekly rolls', which would merely increase costs, inefficiencies, and, somewhat ironically, settlement risk.
- It was further agreed that for the same reasons, open trades that reached 30 business days also should not be in scope. If they were, this would again drive the market to inefficient behavioural change, with trades being closed out and re-opened in advance of the 30-business day threshold. It was also noted that this would create confusion and risks with

respect to routine repricing and cleaning-up of interest (common after 3 months for long-running open trades).

- A member noted that open trades form a significant part of the securities lending market (over 80%), while another added that open trades are the predominantly used transaction type in the credit and EM repo markets.
- The issue of identifying open, or any other out-of-scope SFT, was raised. The Group discussed the fact that currently there is no functionality in T2S to identify SFTs, let alone in- or out-of-scope SFTs. While trading parties may know whether a transaction should be bought in or not, CSDs will not, which will create issues for fails monitoring and reporting requirements. Members reported that work to address this was already underway, and SFTR reporting would also provide the level of granularity needed to determine whether SFTs were in scope or not. It was also put forward that it may not be important for CSDs to know whether a transaction is an SFT, open, or even in-scope in terms of settlement instructions, and that this information only becomes relevant in the event of a fail and subsequent reporting.
- However, while it was agreed that identification of different types of transactions (including in and out of scope) could be important for successful implementation, this was not critical to the specific request for clarification from ESMA.
- The question of 'open-like' transactions, such as short-dated evergreen structures or callable SFTs was raised, with the view that these should also be deemed out of scope on the same basis. The Group was in agreement that clarification on these types of transactions should also be requested. This opened the question as to whether the better approach was first to seek clarification that more 'vanilla' open trades are out of scope, before following up with a request for clarification on more complex structures where the same logic should apply. The Group was divided, with some feeling that it may be better to start with a request that explained the concept of open trades, and why these should be out of scope, then building on this with a later request outlining similar 'open-like' trades. Others, however, thought that it would make more sense to cover all variations of open trades in the submission.
- It was suggested that in either scenario, the wording in any Level 3 guidance would be critical, and that exclusion from scope should be applied to SFTs where the 'earliest contractual maturity', or 'minimum notice period', is less than 30 business days, which would also be consistent with the Level 2 RTS.

Follow up: It was agreed that the ICMA secretariat would redraft the submission in two forms: one based on more vanilla open transactions, and another including more complex open-like structures. The Group could then review and make a final decision on the more effective approach.

2) Calculating the buy-in/cash compensation difference payment

- The ICMA secretariat explained that the provisions for calculating the payment of the difference between parties following the buy-in or cash compensation (as outlined in Articles 32 and 35 of the RTS) are based on 'prices'. Since SFTs are not traded on 'prices' as such, and the fact that this is complicated further by adjustments to the settlement value, such as applying haircuts, any difference calculation would need to be based on settlement value and not prices.
- The Group agreed with the principle and the request for Level 3 guidance to that effect.

Follow up: It was agreed that the Group would review the text of the draft submission, as well as the example provided, and revert to the ICMA secretariat with any suggested edits or enhancements.

3) Best practice for buying-in failing SFT start-legs

- The ICMA secretariat reminded the Group that one of the more challenging discussions from previous industry discussions has been with respect to the actual mechanics and best practice for buying-in SFTs, particularly in the case of the start-leg. Buy-ins currently do not apply to SFTs (in the uncleared space), and contracts such as the GMRA and GMSLA have their own, well-established provisions and remedies for settlement fails, which are tailored to the underlying nature and risks of the transaction type. Buy-ins are generally used for settlement fails in outright cash transactions, not for SFTs.
- The secretariat highlighted some of the practical complications, such as the different implications of a successful buy-in (cancel the start-leg only?) versus going to cash compensation (cancel both legs?), or the case where the failing SFT is in a basket of underlying securities (what do you buy-in?).
- Members pointed out that applying cash market buy-ins to SFTs would be devastating to liquidity and the incentive to lend securities, given the disproportionate down-side of a buy-in compared to the relatively marginal income associated with lending securities. This would almost certainly create a reluctance for firms to enter into term transactions, and at a time when prudential regulators were trying to increase SFT maturities (LCR, NSFR), CSDR was doing the complete opposite.
- The proposal put forward for discussion would be for Level 3 guidance to clarify that on reaching the end of the extension period, rather than applying the CSDR buy-in process, the relevant contractual remedy/ies <u>must be triggered</u>.
- The Group discussed the various remedies available under GMRA and GMSLA contracts, which are broadly similar. In the case of a failing start-leg, the non-failing party has the right to deem this as an event of default by the failing party (which is somewhat extreme and rarely agreed),[1] or they have the right to call for early termination of the transaction, with any accrued repo interest owed to the non-failing party payable up to the termination date.

[1] Calling an event of default in the case of a settlement fail is not standard market practice

- In the case of a failing end-leg, the non-failing party may have the right to call their counterparty into default, but also the right to apply a 'mini close-out'. The latter option provides for the non-failing party to close-out the trade and claim the failing party for the replacement costs of the undelivered collateral.
- It was noted that mini close-outs are not the same as cash market buy-ins (such as those under the ICMA Secondary Market Rules and Recommendations), and while they may have some similarities (particularly from an economic perspective), they are contractually different. The point was raised that the lack of fungibility between ICMA buy-ins and GMRA mini close-outs has been cited as a potential risk management issue (due to the interconnectedness of cash and SFT markets) for many years. While some form of 'connectivity' between the contracts has been explored extensively from a legal perspective, there was no equitable solution that had been found which could satisfy the degree of flexibility afforded to the non-failing party under SFT master agreements.
- Members of the Group broadly agreed that from a market efficiency and risk management perspective, the GMRA/GMSLA remedies were significantly preferable to applying mandatory buy-ins. However, based on the Level 1 and Level 2 regulation, it would be challenging for the contractual remedies to take precedence. Instead, the most realistic solution would be to establish market best practice that in the case of a settlement fail in an in-scope SFT, parties agree to apply the relevant contractual remedies (essentially early termination in the case of a failing start-leg) <u>before</u> the end of the relevant extension period.
- In terms of an ask to ESMA, this would be more about timing issues with respect to the regulatory framework. In the case of a failing start-leg, the request should be that so long as an early termination is notified before the end of the extension period there would be no buy-in obligation. It would be important to stress that once a termination is served (unless otherwise agreed by the parties) further delivery attempts are not possible and the original transaction is terminated (and so cannot be extended).
- The Group felt that this 'best practice' should also apply to end-legs, and that there seemed to be no reason to have an asymmetrical treatment for different legs. Again, the request with respect to failing end-legs would be that so long as the mini-close out is served within the extension period, and the effective close-out date is within the timeline for the buy-in, then there is no buy-in obligation; also noting that a mini close-out, unlike a buy-in, is final. (It was also noted that in this case, the submission with respect to the appropriate calculation of the buy-in/cash compensation difference payment became less relevant.)
- The issue of 'gaming' the regulation was raised, and it was pointed out that in some circumstances, particularly with respect to start-legs, parties may be incentivized to go the mandatory buy-in, rather than opting for the contractual remedy. It was felt that this risk would always remain, but EMSA Level 3 guidance would help to strengthen best practice. Furthermore, the market is self-policing, and any parties gaming the regulation to their economic advantage would struggle to access liquidity.
- In terms of repapering, it was suggested that an additional annex would need to be developed for relevant SFT master agreements whereby parties could agree to an automatic application of the early termination or mini close-out provisions in the event of a settlement fail, and within the parameters of those allowed by the regulation.

Follow up: It was agreed that the ICMA secretariat would rework the submission based on the agreed points, for further review by the Group

4) Other points raised

- The issue of reporting responsibilities with respect to the buy-in process was raised: who should report what and to whom, particularly where there are multiple parties in the settlement chain. The Group was informed that the AFME is very much in the lead on establishing this process for non-cleared transactions, and that all interested industry bodies were very welcome to participate in this workstream.

End ***Andy Hill, ICMA, January 2019***