SPECTRUM

A BRAVE NEW WORLD

THE SETTLE MEN'S CLUB (PART I/3)

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At the beginning of February 2021, a short consultation period that the European Commission (EC) had opened for comments ended. The EC had invited market participants to comment on the terms of the Central Securities Depositories Regulation (CSDR) which, after renewed postponement, is currently set to come to effect on 1 February 2022.

The CSDR is an impactful set of rules on the Central Securities Depositories themselves yet with implications on the wider industry. It was designed to be supportive of a more efficient Eurosystem settlement infrastructure, the so-called TARGET2 System (Trans-European Automated Real-time Gross Settlement Express Transfer System). The latter is the merger of the national payment transaction systems of the Eurozone countries with the system of the European Central Bank (ECB), which was set up in 2008 to foster fast processing of payments and securities transactions. The TARGET2 System is also delivering the data against which the effectiveness of the settlement discipline of market participants can be measured. It operates platforms for the settlement of large-value payments (TARGET2), securities (TARGET2-Securities) and instant payments (TIPS).

But let's get things straight. As mentioned, the CSDR aims at integrating and harmonising the fragmented securities settlement infrastructure across the European Union, with the view to solidify a more efficient capital market in Europe. While this intentional goal is welcomed by the vast majority of market participants, a few requirements under the settlement discipline regime, a subset of the CSDR, have driven some industry groups up the wall – most notably, the mandatory buy-in regime. This had prompted the UK Treasury to decline to implement this part of the regulation some time before there was any clarity over mutual equivalence decisions post Brexit (which still is nowhere near an agreement). While buy-ins are not new, they are usually negotiated at the discretion of the counter-parties involved.

Under a buy-in[2] agreement, the purchasing party in a securities transaction has the right to refer to a third party (a buy-in agent) should the selling party fail to deliver the securities by a negotiated maximum settlement date. If the securities trade between the purchasing party and the buy-in agent incurs higher costs for the purchasing party – because the market price of the security went up during the delivery delay – the original selling party must settle the difference with the purchasing party. In the case of a transaction between the purchasing party and the buy-in agent being concluded, the transaction between the purchasing party and the original selling party is cancelled.

This procedure is designed to put the original counter-parties in the exact economic position they had been in if the original agreement were concluded between the two of them. In practice however, buy-ins are not used much and now the CSDR is making those buy-ins an obligation for all asset classes and trade types, regardless of them being economically sensible and irrespective of whether or not the selling party and the purchasing party would have considered to enter into any such agreement otherwise. This entails major consequences for a variety of market participants with liquidity providers, in our view, having to bear the biggest burden. An increased mathematical risk of a trade failing to settle due to the mandatory buy-in (the original trade failing entirely) will increase the necessity to keep inventory and adjust the risk pricing both weigh on liquidity – since bid/ offer spreads are widening. Preventing liquidity providers from showing quotes for securities they do not own is a disservice, ultimately to the end-investor.

Looking at evidence of how significant the issue is that the regulation aims at addressing, the result is disenchanting. According to the latest figures[2] made available by the T2 System, more than **EUR 1.1 trillion** worth of securities transactions have been settled through the Eurosystem on an average daily basis, allocated over some **607,000 transactions per day** throughout 2019, only four years after the launch of T2S, the securities settlement arm of the Target 2 System in 2015. While this amount of traffic is impressive, it is worth considering another metric, provide by the "recycling period". Transactions that have not been settled at the end of each day, remain in the system which then tries to recycle them for settlement. The ECB publishes figures for the recycling period for a duration of up to 16 days. Only 0.92% of transactions remained unsettled at T+16 which equates to **less than 5,600** of the 607k transactions per day.

> **It should be noted, too, that not all of the unsettled transactions failed to settle due to the behaviour of market participants, but that there are fails resulting from the platform's inability to process a transaction, as the comparison of the platform settlement efficiency indicator (PSEI) and the market settlement efficiency indicator (MSEI) that the system provides show. This comparison will be much more interesting in the 2020 report, specifically when reviewing the impact of the most extreme volatilities during that pandemic-dominated year.**

Such analysis will remain interesting going forward, since the Eurosystem has launched a "TARGET Consolidation Project" aiming at replacing TARGET2 with a "new, modern and secure real-time gross settlement system" in November 2022. The new system shall offer its participants optimised liquidity management capabilities, ensure a single connection to the Eurosystem's market infrastructures and the transition to ISO 20022 standard messages. It will consist of TARGET2 dedicated cash accounts (for bank-to-bank and commercial payments and transactions with the central bank); TARGET2-SECURITIES dedicated cash accounts (for the settlement of securities transactions) and TIPS dedicated cash accounts (for the settlement on the Eurosystem's instant payments platform).

This project is relevant to all Eurozone institutions that currently have or will want to have accounts with their central banks. Those institutions must be clear about which transactions they carry out via their central bank, whether it is executed directly or via a third party and which account structure they require for it. This will have significant impacts on internal processes beyond payments and accounts. These impacts rise with the size and complexity and regional reach of an institution and, what is more, those that won't have concluded their internal preparations at migration date, will be cut off. Cut off from individual payments in central bank money, from the usage of open market operations, from using standing facilities and from the chance to meet their minimum reserve requirements. Last but not least, the migration will be a "big bang" go-live without a parallel phase on November 22, 2022.

It's forgiveable to get cold feet when facing such a mammoth task and I am certainly not putting my head a long way over the parapet when predicting there will be more settlement failures caused by operational rather than liquidity issues. Against this background, European monetary authorities, who have done a tremendous job over the past decade, would be well-advised to give the CSDR buy-in regime another critical review.

The **"Settle Men's Club"** is the first in a series of three articles that examine the impact of technology on modern settlement infrastructures. In part 2, Spectrum's Thibault Gobert discusses how Distributed Ledger Technology Market Infrastructures are on the rise and how the latest draft regulatory framework aims at addressing the weal and woe of yet unexplored terrain.

Read part 2: **A Brave New World – The Rise of DLT Market Infrastructures**
Read part 3: **A Brave New World – T+1, T+2… T0?**

[1] *as opposed to a "sell-out", after the buyer of a security fails on its obligations*
[2] *https://www.ecb.europa.eu/paym/intro/publications/html/ecb.targetsecar202005.en.html*

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