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# BETTER NEVER THAN LATE?

The Central Securities Depositories Regulation (CSDR) is a key European financial market regulation, aiming at introducing a harmonised framework for financial market infrastructures throughout the Union. It came into force in 2014 with implementation packages phasing in over several years. The third and last element, the Settlement Discipline Regime (SDR), has been the most controversial. **Thibault Gobert, Head of Liquidity Pool at Spectrum Markets,** expects that the latest developments may appease the critics' anger.

## Thibault, for those not too familiar with the issue, can you please give a brief overview of the CSDR and the SDR?

The CSDR is a comprehensive set of rules on Central Securities Depositories (CSDs) themselves, but also effecting the broader industry. In phase one and two, the offering of omnibus and segregated accounts and the reporting of internalised settlements became compulsory. The former required depositories to provide their clients the option to choose whether they want their securities to be held in an omnibus client segregated account or in an individual client segregated account. The latter refers to the requirement to report the volume and the value of securities transactions settled internally on a quarterly basis to the NCA[1]. The third implementation package brought the SDR under the Settlement Discipline Regime, requirements were introduced that aim at preventing settlement fails by improving consistency of data and at preventing settlement delays by means of cash penalties and mandatory buy-ins.

## It's these buy-ins that have been discussed very intensely ever since they've been introduced. What is the background?

Buy-in agreements are entered into to allow the buyer of a security to buy this security from a third party where the original seller misses the appointed delivery date. Any extra costs this third party transaction entails for the buyer have to be borne by the original seller who didn't deliver in time. Where, in specific cases, these mutual agreements are sensible, the parties will individually agree the terms accordingly.

The buy-in regime under the SDR, however, was set to become a mandatory contractual element of all sorts of trades and asset classes, irrespective of them being economically reasonable or not.

## You have been a strong opponent of this regime – is it because it is detrimental to the market makers' business?

For them, such a regime would have proven particularly negative but they wouldn't have been the only ones to suffer from it. Imagine you're a regulated financial entity and securities trading is your daily business. A contractual buy-in obligation for each security you have to deliver poses a determined mathematical risk that carries a premium over the objective risk of a delivery failure. This premium will consist of the costs your buying counterparty incurs when settling with a 3rd party and that you have to bear under the agreement.

Now imagine you're the buying counterparty to the trade. In an otherwise liquid business, what would be the reasons for you to expect the seller might not deliver, if not for the counterparty credit risk? The highest risks will certainly be market related ones. As a buyer you don't care because the buy-in agreement allows you to shuffle off these costs to the seller.

Back to the seller. The risk of missing delivery is now a worst-case scenario, fully unfolding from a mathematical perspective: you have to risk-price the costs for your counterparty buying the security elsewhere as a result of market deterioration, i.e., in a scenario where the trade would be equally difficult to settle with probably every other counterparty. In order to cover this risk, you can either build capital buffers or keep sufficient inventory – both options, however, will make the trade uneconomical. Hence, such a regime would have significantly disincentivised market participants from showing quotes for securities not in their stock and would have led to bid/offer spreads widening sharply.

## This sounds as if the regime was already off the table, but this is not the case. What has happened in the meantime?

In September 2021, ESMA[2] asked the European Commission to postpone the mandatory buy-in regime, which the Commission did, though via very unusual channels. It announced the postponement via Twitter[3], but simply because there wasn't enough time left until the SDR introduction on 1 February, 2022.

In March 2022, the Commission introduced a proposal[4] regarding settlement discipline, cross-border provision of services, supervisory cooperation, the provision of banking-type ancillary services and requirements for 3rd country CSDs. Therein, it proposed a two-step approach to finalise the SDR whereby the timeline for the implementation of the mandatory buy-in regime should be revised and the postponement period should have been used to monitor the SDR's cash penalty effects in order to derive the most appropriate approach to the mandatory buy-ins.

In other words, the Commission was not willing to look into entirely skipping the buy-ins. It argued that settlement fails in the European Union would remain consistently higher than in other major financial markets and that the buy-ins should be kept in case the cash penalties don't sufficiently discipline market participants. However, in August, the ECB[5] took a stand not coherent with the Commission's.

## What is the ECB's position?

It issued an Opinion[6] in August on the proposed changes to the CSDR within which it expressed its concerns that mandatory buy-ins may entail "significant interference in the execution of securities transactions and the functioning of securities markets".

It further argued that, should the buy-ins be introduced anyway, this should not be applicable to securities financing transactions[7] as these don't generate an outright open position between the trading parties justifying a buy-in.

You may argue that the ECB has no mandate in association with introducing legislation to amend the CSDR. However, its assessment may have a stronger impact than the objections of industry associations that have been criticising the buy-ins for a long time.

## An even more important comment has come from the European Parliament lately...

That's right. In an October report[8] that didn't gather so much public attention, the Parliament proposed to further clarify the scope of the cash penalty regime and, more notably, to entirely discard the mandatory buy-ins.

With reference to the extreme market volatility in 2020, the Parliament explained that such rules constitute "a disproportionate interference in the execution of securities transactions and the functioning of securities markets", which is very similar to what the ECB has reasoned. The report adds that mandatory buy-ins "pose significant risks for market liquidity and financial stability in the Union" which could jeopardise its global competitiveness.

While this is not yet a final decision, it underlines the severe detrimental impact a mandatory buy-in regime in its current form would have, even if it came into force only in 2025. In addition, I consider it a strong indication that the Parliament will not adopt a legislative proposal as currently drafted by the Commission. In that sense, I am confident that the mandatory buy-in regime will not become part of the SDR.

## Thank you very much!

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[1] National Competent Authority
[2] The European Securities and Markets Authority
[3] https://twitter.com/McGuinnessEU/status/1463556930778144781
[4] https://ec.europa.eu/finance/docs/law/220316-csdr-review-impact-assessment_en.pdf
[5] European Central Bank
[6] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52022AB0025&qid=1664209054758
[7] Repurchase agreements (repos), buy-sell back and sell-buy back transactions (reverse repos), securities lending and margin lending transactions
[8] https://www.europarl.europa.eu/doceo/document/ECON-PR-736678_EN.pdf



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