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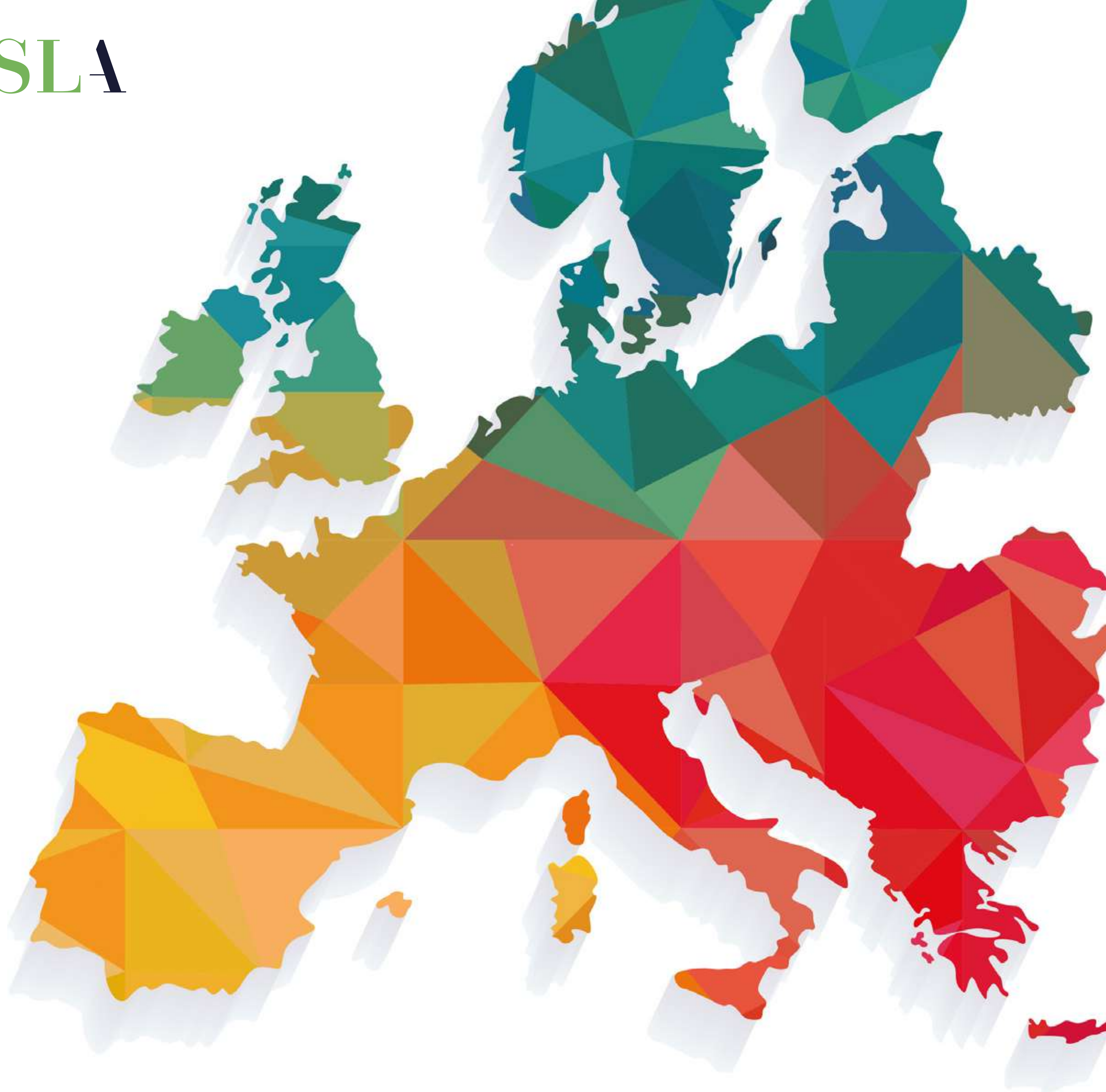

Pirum Systems:
Central Securities Depositories Regulation

Introduction

Financial markets are now accustomed to regulatory change and associated implementation challenges. Regulatory changes require significant investment to not only understand the requirement but also to successfully implement and adhere to on an ongoing basis.

Unfortunately, regulatory change isn't coming to a halt just yet, and the next two years are likely to pose the biggest challenges to date for the securities finance industry.

2019 and 2020 are likely to be red letter years in securities finance, with SFTR (The Securities Financing Transaction Regulation) going live in 2020 and the introduction of a new landscape surrounding settlement discipline, introduced by ESMA as part of CSDR (The Central Securities Depositories Regulation) in September 2020. Despite the title of the regulation, CSDR will impact far more than just CSDs (Central Security Depositories).

EU market participants and liquidity providers have expressed deep concern that CSDR has the potential to disrupt the established market standards and operating models.

Market participants will require robust technology solutions to help them navigate through the complexities and challenges of CSDR.

In this article, we intend to uncover the key challenges of CSDR and answer some of the recurring questions we are currently discussing with our clients.

Furthermore, and arguably most importantly we will explore how firms can help to navigate the challenges of CSDR and best position themselves to ensure compliance with the new settlement discipline regime.

What is CSDR and Who is In Scope?

The CSDR regulation (No 909/2014) is an EU/EEA regulation, which not only introduces measures for the authorisation and regulation of EU CSDs but sets out to increase the safety and efficiency of securities settlement infrastructures in the EU. This effectively means CSDR will impact all transactions, including SFTs, which are intended to settle on an EU/EEA CSDs. Importantly this will apply to any transaction that is due to settle on an EU CSD, regardless of where the trading entity is domiciled.

Chapter III of the regulation outlines the settlement discipline regime alluded to above. Article 7 includes measures that will be introduced to harmonise settlement efficiency and will not only mandate cash penalties for settlement fails, but more significantly, will introduce mandatory buy-ins. SFT's which are termed for 30 business days or more will be in scope for mandatory buy-ins, effectively providing exemption for SFT's where the term of the SFT is less than 30 business days.

Settlement Discipline: Mandatory Buy-ins and Cash Penalties

CSDR requires CSDs to monitor and facilitate transactions to prevent settlement failure, and where applicable ensure market participants who fail to deliver their securities are subject to both cash penalties and buy-in procedures. This is a huge and contentious shift from current market practice, where the buy in is both discretionary and a relatively rare occurrence (especially within EU securities finance markets). The buy-in will now be mandatory and a regulatory requirement.

Here we will highlight the key factors that are driving the mandatory buy-in, what's in scope and the key time frames to be aware of.

The trading entity who has been failed to will have a responsibility to initiate the buy-in process, which will include them appointing a buy-in-agent to carry out the process.

The exception here is transactions which are cleared via a CCP (central counterparty), where the CCP will be responsible for initiating this process. The buy-in must be initiated 4 business days after intended settlement for liquid shares and 7 business days for all other instruments, once initiated the buy-in must be completed within the same prescribed time frame - 4 business days for liquid and 7 business days for all other instruments.

As a last resort the buy-in can be satisfied by the way of cash compensation, in this scenario the original transaction would be cancelled, and a payment will be made from the failing party to the failed to party based on the delta of the current market price and the agreed upon original price.

Furthermore, although there are similarities between a conventional buy-in that the market is currently familiar with and the CSDR mandatory buy-in, there are also key differences. Perhaps the most contentious difference relates to the asymmetrical payment structure of the buy-in or cash compensation, as it can only be paid in one direction.

This clearly has the propensity to adversely affect the failing party financially if the price does fall.

Unfortunately, the complexity does not stop at mandatory buy-ins. Financial penalties will also be introduced for failing transactions, this will no longer a formal agreement but a legal obligation. See Exhibit 1 on the following page for further details.

Exhibit 1. Source: Commission Delegated Regulation (Eu) 2017/389

	Type of fail	Rate
1	Settlement fail due to a lack of shares that have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	1,0 basis point
2	Settlement fail due to a lack of shares that do not have a liquid market within the meaning of point (b) of Article 2(1)(17) of Regulation (EU) No 600/2014, excluding shares referred to in point 3	0,5 basis point
3	Settlement fail due to a lack of financial instruments traded on SME growth markets, excluding debt instruments referred to in point 6	0,25 basis point
4	Settlement fail due to a lack of debt instruments issued or guaranteed by: a. a sovereign issuer as defined in Article 4(1)(60) of Directive 2014/65/EU; b. a third country sovereign issuer; c. a local government authority; d. a central bank; e. any multilateral development bank referred to in the second subparagraph of Article 117(1) and in Article 117(2) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (1); f. the European Financial Stability Facility or the European Stability Mechanism.	0,10 basis point
5	Settlement fail due to a lack of debt instruments other than those referred to in points 4 and 6	0,20 basis point
6	Settlement fail due to a lack of debt instruments traded on SME growth markets	0,15 basis point
7	Settlement fail due to a lack of all other financial instruments not covered in points 1 to 6	0,5 basis point
8	Settlement fail due to a lack of cash	Official interest rate for overnight credit charged by the central bank issuing the settlement currency with a floor of 0

Potential Impact and Solutions:

CSDR will inevitably pose numerous challenges for securities finance participants, and the timeframe of the implementation has the potential to interfere with firms looking to upgrade legacy systems or build a technology solution to assist in overcoming these challenges.

Therefore, it is vital that firms utilise tools that are currently available to mitigate economic and reputational impact.

In addition, it is important that firms consider how they will process and reconcile the penalties and mandatory buy-ins that seem to be inevitable given the scope of the new rules. Established points of connectivity that technology vendors and market infrastructures can provide will now become essential for those firms looking to comply with the new regulations and avoid the penalties that are being introduced.

On the following page is a summary of some of the key CSDR post trade challenges that may contribute to fails within securities finance and how firms can ensure that they are best placed to avoid them.

In conclusion

Perhaps CSDR has not received as much attention or press as MiFID II, SFTR or Brexit to date, however the reality of CSDR and its' strict settlement discipline regime has the potential to present market participants with difficult challenges. Whilst there are some overlaps between SFTR and CSDR, ESMA have largely tried to avoid market participants duplicating their reporting requirements by removing fields such as 'place of settlement' which appeared in the first consultation papers. Ultimately market participants who ensure that robust technology solutions and processes are in place well before September 2020 will help protect themselves against the many risks posed by CSDR and SFTR

Challenge	Potential Solution	Benefits
Consistent pre-matching of new transactions	A real-time contract compare/matching service	Ensure all settlement related fields are matched moments after trade booking Report and monitor fails real-time
SSI set up, amendments and matching	A real-time contract compare service	Potential to match and reconcile SSI's with your counterparty pre and post trade
Timely collateralisation	A fully integrated & real-time exposure management tool	Increased visibility of exposure across your full book which allows for efficient collateralisation and matching of pre-paid loans
Timely loan/instruction release	An auto loan release mechanism	Avoid fails by releasing loans immediately once collateralised avoiding manual delays Instruction release for loans / returns ensures that instructions are only released to market once matched on all key settlement criteria
One to many settlements/reallocations for loans and returns	An automated return service coupled with a real-time contract compare service	Ensure correct returns are booked between borrower and lender and match on fund where applicable, which should ensure correct SSIs Also ensures correct TD, SD, DVP/FOP, Qty etc. all matched so no manual key in errors Automation ensures instructions get matched in the market earlier, often prior to settlement date, which increases settlement rates