

CSDR

Its heart is in the right place

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How will CSDR impact custody markets?

Daniel Carpenter: With both the buy-side and sell-side looking to their custodians to help them navigate the new rules, their level of preparedness is key. The custody arms of many global houses were among the first to engage with Meritsoft with regards to their CSDR project plans and our solution. Having a working platform that can handle the data and communication challenges well ahead of the implementation date is of paramount importance to them, and to their clients, in order to comply with the new regulatory requirements.

Paul Baybutt: The Central Securities Depository Regulation (CSDR) will have one of the most significant impacts on the settlement of securities since dematerialisation.

The introduction of penalties and mandatory buy-ins will not only impact the liquidity of the assets settling in European central securities depositories (CSDs), but will introduce significant operational changes to implement them. Firms unaccustomed to buy-ins will now not only be forced to pay more attention to settlement, but will also need to have processes to enact buy-ins when mandated.

Christine Strandberg: So far the direct impact of CSDR on the overall custodian community has been fairly limited. To the extent that CSDs have been required to perform substantial changes to adapt to CSDR, sub/local custodians have definitely been required to also perform corresponding system changes. But before the implementation of penalties and buy-ins, custodians could in many respects choose not to implement support for some or even all new functionality/services. This will now change.

As penalties will be both debits and credits, custodians must be able to report and forward them.

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Daniel Carpenter, head of regulation at Meritsoft, a Cognizant company

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Christine Strandberg

As clients will surely wish to limit their exposure, custodians need to offer functionality that will enable straight-through processing (STP) of instructions and cancellations, especially when it comes to matching, as well as ensuring as high settlement rate as possible.

Many long-term effects of the regulation are still not visible and whether or not the desired competitive effects will play in is doubtful while the jury still is out on the robustness and stability effects.

Karan Kapoor: CSDR impacts all market participants within the securities trading value chain, specifically direct CSD participants. Custody services providers are an integral part of this market, hence, will play a major role in ensuring that the CSDR regulation in its entirety is able to achieve its key objective of improving the efficiency of the market.

Custodians have been impacted not only by the recent infamous settlement

discipline regime of CSDR but also by many key requirements of the regulation such as daily reconciliation, segregation and disclosures, as well as settlement internalisation, which went live in July 2019.

Looking forward, all European custodians will need to – if not already – prepare for the impacts of the settlement discipline regime, from not only the perspective of reaching compliance in isolation but from the wider industry and their client perspective in order to help the market become more efficient.

As a minimum requirement and as direct CSD participants, custodians will have the responsibility to ensure their clients efficiently and accurately receive all incoming penalty information so that the cash penalty rule can be enforced.

Custodians also will play a part in the mandatory buy-in regime by ensuring failing transactions are put on hold, released or partially settled in line with the regulatory requirements. Custodians may also be required to support the enforcement of the allocation and confirmation requirements by ensuring that their clients adhere to the revised settlement instruction format.

However, many custodians are viewing this as an opportunity to provide more value-added services. Instead of just being a passthrough mechanism of information coming from the CSD network, custodians can actively support their clients to meet the obligations of the regulation.

Providing targeted and enhanced fails information, proactively helping clients avoid settlement failure and actively participating in the workflow for fails remediation are only some examples of value added CSDR services we've seen developing across the industry.

The more ambitious service providers are considering inventory and collateral management agendas, depot management or even executing buy-in transactions as agents to their clients.

This is also an opportunity for custodians to enforce better settlement behaviour across their client network.

This is fuelled by the fact that CSDs will report their top 10 failing participants to national competent authorities (NCAs) and custodians will have to face the direct consequence of this, as they will be blamed for their clients' shortcomings as the intermediary.

Every custody service provider is impacted by CSDR. How each market participant chooses to respond will impact its market position in the years to come.

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What are the biggest challenges around the regulation and why are there particular concerns around the mandatory buy-ins process?

Baybutt: The biggest challenge around the regulation is how it should be interpreted. The industry needs the regulator and European Commission to provide clarity on how the regulation should be applied. There have been different interpretations of the level 1 and level 2 text and these interpretations need to be ascertained so that firms can implement the regulation as it was intended.

Pardeep Cassells: The regulation is opening the market up to many unknowns and to the introduction of processes that are new to these markets. The core challenges, from conversations we've had with market participants, are around managing increasingly complex workflow and trying to do this efficiently. The notification and data requirements require a significant amount of coordination and collaboration across the

market so finding the right way to manage this is key. Although buy-ins are not entirely unfamiliar territory for participants, the approach that CSDR mandates is certainly novel for the region. Concerns around this process include the complexity of confirming eligibility (and parameters thereof), timing, potential volume, cost, lack of confirmed buy-in agents, sourcing of securities, complexity on the 'pass on' scenario, inconsistencies and lack of clarity in some regulatory aspects and finally, the potential for organisations to resort to manual processing and create manual effort for counterparts and stakeholders.

Carpenter: There are major concerns around the mandatory buy-in process, particularly for the tier-one banks. Under the buy-in rules, what is deemed a liquid security is due to be settled after four days, while an illiquid security needs to be settled after seven. But how does a firm agree what is liquid and what is illiquid? Firms will have to reevaluate the security every day that the price falls based on their data feeds. This highlights the heightened importance of a joint market view to underpin these assessments by individual houses.

Investment, brokerage and custodian banks will now face a huge strain from an operations and associated cost perspective with all the necessary compliance data, processing, and penalties. They will need to consume and provide data, as well as calculate fees, on not only a daily basis, but also an intra-day basis. This will bring about significant changes in how investment banks manage



Christine Strandberg, product manager, investor services, large corporates and financial institutions, SEB

Strandberg: As a sub/local custodian, the main challenge of the penalties regime has so far been the uncertainty – what will CSDs deliver to us, what are we to deliver to our clients, what will the market practice be, when can we perform testing, when can our clients perform testing, etc. For a global custodian, this is only magnified; the difficulties increase substantially the more providers you have. The mandatory buy-in process is primarily an issue for the trading side. Custodians are required to pass on information and instructions, but as we are otherwise not involved, the main concern for everyone is the potential impact on liquidity in the market if it is not possible to pass on buy-ins to the next party in the transaction chain, and instead perform buy-in for each individual settlement transaction.

the pre-matching and associated settlement activities. With no standard market practice for dealing with this issue, market participants will need to try and figure out a way to share information around penalties and buy-ins. For investment and custodian banks, the costs of generating potential buy-in notifications and validations could be far greater than they initially thought.

Kapoor: Uncertainty, lack of precise clarity around key requirements and market infrastructure preparedness are the key issues that the industry is trying to work around.

At this point, it is public knowledge that key industry bodies are lobbying hard to seek another delay to the CSDR settlement discipline

regime. How successful this effort will be is yet to be seen but it adds to the uncertainties around planning for programme delivery.

Key SWIFT changes that are critical to the success of the regulation are only going to be deployed in November, which leaves the industry a relatively short window to adapt, test and deliver in time for February 2021, unless the date moves.

Delta Capita's CSDR client work has identified many details and nuances around the mandatory buy-in regime that still need clarification: who is going to be the buy-in agent, how is the market going to deal with settlement chains, how are buy-ins going to be reported and enforced, how will the CSDR buy-in rules co-exist alongside the International Capital Market Association (ICMA) rules?

These are some of the open questions that are keeping the industry on its toes. There are also broader concerns around the impact of the buy-in regime on market liquidity and in general its effectiveness to promote the CSDR objective.

The most ignored topic within the CSDR tapestry is the legal repapering requirement. All client and counterparty contracts will need to be repapered to enact CSDR impacts.

Scope, methodology and apt legal wording is currently not clear, which is a challenge for outreach planning.

As the industry awaits required clarification from industry bodies such as ICMA, the International Swaps and Derivatives Association (ISDA) or selected external counsel, this topic is steadily becoming the critical path, similar to previous Markets in Financial Instruments Directive (MiFID) and Brexit programmes.

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Karan Kapoor, head of regulatory change and technology, Delta Capita

How has the ongoing COVID-19 pandemic affected firms preparing for CSDR?

“As the industry adjusts to new ways of working, our engagement with the marketplace indicates that CSDR and fails management projects are very much on the radar of houses right now”

Carpenter: With the need to focus on near-term operational priorities, most firms have by necessity had to divert resources to other projects, such as the Securities Financing Transactions Regulation (SFTR), which has had an inevitable impact on CSDR preparedness.

Simultaneously, the dramatic increase in trading volumes that characterised the first quarter exacerbated the need for more effective management of settlement processes and oversight of real trade expenses.

As the industry adjusts to new ways of working, our engagement with the marketplace indicates that CSDR and fails management projects are very much on the radar of houses right now.

Ben Pumfrett: The initial impact of the COVID-19 pandemic in March, which resulted in the transition to work from home arrangements combined with the management of exceptional transaction volumes, shifted the market's focus from regulatory initiatives to day-to-day operations. The regulatory agenda has since regained prominence, but the pause in the intervening months did impact progress.

Kapoor: Based on the work Delta Capita is doing with our clients, we are inclined to say it hasn't. As strange a time that the COVID-19 pandemic has brought, it has also proved the resilience of this industry. The workforce has adapted to this new way of working fairly seamlessly without any visible loss of productivity. SFTR going live in July after only three months delay is a testament to this. That being said, has the COVID-19 pandemic delayed some key regulatory consultation rounds or industry body discussions? Probably yes, however, we don't believe these delays to have significantly impacted progress.

For market participants who have experienced severe delays due to COVID-19, this is definitely a time to stock check and improve internal resilience processes because the world of remote and satellite working is here to stay.

Baybutt: While the industry responded remarkably well to COVID-19, some firms diverted project resources into operations to deal with the volume spike and higher absences. At HSBC we were able to manage this without diverting resources from key regulatory projects ensuring

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that we can continue to adhere to the regulatory timetable.

Cassells: The feedback we've had from firms is that preparation has not been delayed by COVID-19. The market volatility and fluctuations had a significant impact on operational teams but as the CSDR preparation is still in flight with IT and change teams, it seems that they were able to stay broadly on track. Certainly, we have seen increased engagement and appetite to discuss CSDR in the last four months, with firms firmly moving towards making solution decisions.

Strandberg: This differs between firms, but there has definitely been an impact to custodians and CSDs. The industry has generally handled COVID-19 well, but it has required a reallocation of resources within firms. This, together with working from home or alternative locations, has affected ongoing development, of both systems and processes.

Do you believe industry participants need more time, despite the deadline already being extended?

“It is difficult for firms to be ready in a situation where the regulation is still not fully understood”

Cassells: A recent survey by Baringa on Market Readiness for CSDR suggested that less than a third of respondents fully understand what their new data requirements will be under CSDR and that nearly half are concerned that lack of regulatory clarity is the key challenge preventing them from being ready for CSDR.

It should be borne in mind that there are currently 31 points awaiting clarity from the European Securities and Markets Authority (ESMA), according to their own record.

It is difficult for firms to be ready in a situation where the regulation is still not fully understood. This, when combined with the lack of confirmed buy-in agents and other factors such as CSDs not yet providing sample messages, really is going to make it challenging for firms to be fully ready in time for the extended deadline.

Baybutt: Yes, the extended deadline has been proposed to ensure the market infrastructures, mainly SWIFT and the T2S penalty mechanism, are in place to support CSDR. The delay does not address the uncertainty the industry still has around how to implement. It also does not give time for the European Commission to consider the wider market impacts and the effect the settlement discipline regime will have on liquidity.

Strandberg: Yes. We fully support the request from the European Central Securities Depositories Association (ECSDA) for a further postponement of the CSDR settlement discipline regime.

Kapoor: The initial deadline was extended to align to SWIFT message changes release timelines as the industry has a huge dependency on this infrastructure, as opposed to participant readiness.

However, the industry is still awaiting clarifications to many open regulatory questions and we also understand many European infrastructure providers are not going to be ready on time. Moreover, many firms have been pre-occupied with SFTR preparations, and CSDR progress has suffered from resourcing and other constraints. It is safe to assume that the industry will definitely welcome a delay which would not only allow better preparation but also cleaner enforcement of the CSDR regulation. And given the recent announcement by ESMA on the 28 July, a further delay seems even more likely.

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Paul Baybutt

Pumfrett: The further extension to February 2022 currently being considered would be welcomed by industry participants. This additional time would provide firms with the opportunity to solidify approaches and ensure that all the nuances of the settlement discipline regime are clear.

Carpenter: As with many regulations, markets inevitably need more clarification on rules and then time to interpret and implement appropriate solutions. We know from our long experience in the delivery of regulatory solutions that rule consensus takes time and that they subsequently change shape, pre- and post-go-live dates, for example, with MiFID II. Nevertheless, new rules will arrive, and their impact must be managed. Our own research suggests that it's very much a case of keeping the foot on the pedal.

We polled 100 operations staff across brokerage houses, custodian banks and asset managers at the end of July and found that 68 percent are continuing with their CSDR projects irrespective of the delay. And while 18 percent were waiting for industry-wide clarification before pausing their project, none have put their CSDR projects on hold.

What are your thoughts about the UK dropping the CSDR settlement discipline regime as part of its adoption of EU regulations post Brexit? Will this create more challenges for the UK?

“For the majority of firms that trade across both UK and EU markets, they must now account for different regimes and integrate split models into their programmes”

Ben Pumfrett

Pumfrett: Very few buy-side firms are limited only to the UK market. For the majority of firms that trade across both UK and EU markets, they must now account for different regimes and integrate split models into their programmes. In the UK, it is only CREST settlements that will not be in scope and CREST are continuing with some modifications such as making the ‘place of trade’ mandatory. There also remains uncertainty on the impact to cross border transactions. Ultimately, the UK may still announce the adoption of settlement fines through its own rules as the objective of reducing failed and late settlement is widely supported.

Cassells: From a purely operational perspective, firms will still be required to adhere to the CSDR settlement discipline when trading in Europe, so this change is likely to lead to further complexity when making determinations and managing workflow.

Carpenter: Most capital markets firms operate globally, having footholds or transactions following through the UK, EU, US and Asia Pacific regions and so they will be pulled into CSDR. There will also be many UK-based investment managers settling across the EU who will need to ensure they are compliant with this regulation. In short, the UK dropping the CSDR settlement discipline regime will not have a significant impact on the necessary steps needed to ensure compliance.

Firms may focus on reducing the number of trade fails overall by improving the processes involved in trade settlement, which is both best practice and commercially beneficial. Within the UK, dropping the CSDR settlement regime could have an impact on trading volumes as some institutions may look to trade and then settle more UK trades, specifically to avoid CSDR settlement issues.

Strandberg: Good question. At this time, it is difficult to assess whether the settlement

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Pardeep Cassells, head of financial products, Access Fintech

discipline regime will result in any substantial benefits, and it is quite costly to implement. Is there a business case at a market level for the UK? Perhaps not. That said, UK custodians will likely have to implement all the functionality in their systems anyway.

Kapoor: Most of our securities market clients have pan European operations – and since

CSDR is still very much enforced across the EU, the show must go on. The small number of organisations that are super specialised in the UK market and only deal in securities settled in CREST can breathe a sigh of relief – the rest remain unaffected.

How the market reacts remains to be seen – will European flow be diverted into the UK where

possible? Or will clients demand EU settlement to conform to a single rule? One can only speculate at this stage.

In addition, the current position is that the UK won't implement the settlement discipline regime as is currently drafted. Will the UK coin a variant of similar rules in the future? Only time will tell.

“The proposed delay to CSDR until 1 February 2021, has meant that the settlement discipline regime in its current form could not be implemented into UK law”



Baybutt: The proposed delay to CSDR until 1 February 2021 has meant that the settlement discipline regime in its current form could not be implemented into UK law.

An equivalent regulation would need to be proposed and passed for the UK to adopt the settlement discipline regime.

By HM Treasury stating that they will not implement the EU settlement discipline regime, they have removed the uncertainty faced by firms not yet knowing the answers to be provided by the European Commission.

However, as CSDR will still apply to UK firms settling trades in the European CSDs, we still need clarity from Europe as to how the regulation should be implemented.

Longer term, the UK will be able to consider how they should address the settlement discipline regime and will have time to ensure the matters open in Europe are considered.

Paul Baybutt, director, senior product manager, global middle office product, securities services, HSBC

How will firms handle the costs of a failing-trade under CSDR? Why is this a lot higher than the cost of a failing-trade under a non-CSDR regime?

“At this time, it is difficult to assess whether the settlement discipline regime will result in any substantial benefits, and it is quite costly to implement”

Strandberg: For custodians, this remains to be seen. Investments in increased STP, both with regards to system functionality but hopefully also higher attention to standard settlement instructions (SSIs) and deadlines, should result in a decrease of staff in the settlement instruction process. On the other hand, those effects seldom play out as planned and besides, the STP rate is very high.

One would think that the take up for autoborrow arrangements to reduce failed trades would pick up steeply but so far, we have not detected the expected sense of urgency. This combined may mitigate the increase of staff necessary to monitor penalties, investigate cause, validate appeals, report buy-in progress, and other potential tasks resulting from the settlement discipline regime.

Baybutt: We expect to pass on the costs of failing trades to the participants responsible for the fail and then for these to be redistributed to the party who has not received the securities. Based on the current fail rates across the industry we anticipate that the buy-side investors will receive more redistributed amounts than pay penalties.

Kapoor: We think it's prudent to break this question out into two distinct parts. First, why is the cost of a failing trade under the CSDR regime higher than pre-CSDR? The answer to this is fairly straightforward: under CSDR failing trades will be subject to mandatory cash penalties and will risk being bought in.

Each of these punitive consequences will bring financial impact to the failing counterparty, who will receive a hefty penalty per day the trade has failed from the relevant CSD until the end of the extension period, beyond which the transaction will be bought in. Bought in transactions, too, carry a huge bill which includes fees for buy-in execution, any market linked price difference for the security or any compensation that might be levied.

As Delta Capita helps its clients consider how to allocate CSDR costs we are seeing a number of permutations emerge. Depending on where the firm is in the value chain it may either choose to absorb the cost or pass it on to the next participant in the chain. Careful analysis needs to be done on the various scenarios that can emerge

when a trade fails. Is your firm buy side or sell side? What is your contractual relationship with your client with regards to settlement? How big is that client for your business? Are you in an onward chain? These are only some of the questions that need to be asked before the right answer can be ascertained.

Carpenter: Under CSDR, daily penalties of failed trades will be calculated in basis points and vary by the type of instrument transacted, etc.

Although this doesn't initially sound earth-shattering, a tier one investment bank could potentially experience over 10,000 failed trades per day in the core European markets, with associated penalties adding up quickly.

On top of this, firms are also likely to incur operational costs as they look to update existing infrastructure or introduce new systems to remain compliant.

Firms will also need centralised and automated settlement fail processes tracking the range of securities, to ensure they are not caught out by unexpected fees.

Using an integrated CSDR management solution means firms will be able to manage all the various requirements of CSDR on one single end-to-end platform, mitigating these potential risks and the costs of upcoming penalties and buy-ins through efficient issue resolution.

Although there is a lot of concern around CSDR, how do you expect the regulation to play out?

Kapoor: We strongly believe that the CSDR regulation has its heart in the right place. There is passionate agreement across the industry that the objective of market efficiency improvement that CSDR is pursuing makes sense and is required. Hence market participants themselves want to ensure that CSDR meets its objective.

Having said that, some requirements are seen to be more effective than the others, while some requirements raise concerns about unintended consequences, but it's definitely fair to say that a regulation the market is trying to get behind will definitely reach a positive outcome. There may be some realignments along the way – how they transpire is yet to be seen.

At Delta Capita we have a mature CSDR offering and have been advising and supporting our clients design and deliver the right CSDR solution for their organisations. Our deep industry expertise, our DNA in securities operations and

Pumfrett: If the implementation of the regulation is deferred, there may be industry efforts to further push for the decoupling of settlement penalties and buy-ins.

Some proponents suggest that regulators consider introducing settlement penalties first, to determine if this has the desired impact on reducing settlement fails and late settlements before implementing a buy-in regime.

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managed services and our many relevant digital assets such as DC-Transform, Fraxx and Modus can help accelerate CSDR initiatives.

Carpenter: With the planned penalty and buy-in rules under CSDR, the broader fails management process is now firmly in the spotlight.

Whatever the outcome of current discussions with the regulator, firms do struggle to manage fails across multiple systems and multiple regions, across different asset classes and clearing houses.

Irrespective of possible CSDR implementation delays our goal is to provide a complete fails management capability, one that handles CSDR rules and more, with a 'single pane of glass' that enables operations teams to manage their fails effectively and in a single place.

Strandberg: We hope that settlement rates will increase with the introduction of penalties (as per CSDR).

But unless certain changes to the settlement discipline regime are performed, primarily around mandatory buy-ins, the overall impact to securities markets may be negative.

Baybutt: Momentum is gathering for a further delay. ESMA has confirmed they are preparing a proposal to delay the entry into force of the CSDR settlement discipline regime until 1 February 2022.

This is due to the impact of the COVID-19 pandemic on the implementation of regulatory projects and IT deliveries by CSDs and came as a request from the European Commission.

This delay only provides for the implementation of settlement discipline in its current format one year later; it does not provide that the European Commission will review settlement discipline. However, later this year, as with all European regulation a periodic review of CSDR will take place.

Normally, this would only consist of reviewing the in-force regulations, however, there is much industry lobbying for the European Commission to include settlement discipline in this review, which could open up the possibility of changes to the regulation.

Cassells: In a previous role, I was a broker and custodian relationship manager and worked with those organisations to understand the key drivers of mismatches and failing trades.

In a four year window, we saw a dramatic increase in timely matching and settlement with many firms eventually consistently achieving in excess of 99 percent timely settlement. The fails, where they did occur, were caused by three key issues: failure to deliver, SSI discrepancies, and inventory issues – all of which are avoidable.

Despite the concerns around CSDR at this time, it will absolutely incentivise market participants to resolve the thematic issues above to ensure timely and accurate matching and settlement of trades, and this can only be a good thing.

Are you interested in taking part in the next AST panel? If so, please get in contact with Justin Lawson: justinlawson@assetsservicingtimes.com

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