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Improving CSDR settlement discipline to support CMU objectives

The creation of an integrated and efficient European capital market – the goal of the CMU project – is among the most important goals currently being pursued in the EU. A crucial element of this framework is the safety and efficiency of the arrangements required to finalise securities transactions. There is a clear flow in operations and interdependency between trading and post-trade processes, with efficiencies passing through from one to the other.

In that context, the objective of the CSDR Settlement Discipline Regime (SDR) – to increase settlement efficiency in the market and decrease settlement fails – is the right one. We commend the European Commission for recently consulting on the details of the regime to make sure they are fit for purpose. For example, we believe that a targeted, appropriately calibrated cash penalty regime – as currently envisioned in the SDR – will have a positive impact on settlement efficiency on a standalone basis, sufficiently penalising sellers while compensating buyers for late delivery, ultimately leading to lower settlement fails.

However, we believe one particular provision of the SDR – the mandatory buy-in regime – risks reducing the efficiency and liquidity of European capital markets, leading to greater costs to investing in European securities, contrary to CMU aims. The issue is with the mandatory nature of the buy-in regime for non-CCP cleared transactions, which makes it insufficiently flexible by removing investors' choices and ignoring the particular liquidity profile of the securities. This is likely to fundamentally impact liquidity providers' ability to make markets. To adjust for the expected cost of being bought-in, market makers may have to add a premium to their prices – widening the bid-offer spread – or they may simply not make an offer price on an enquiry. Asset managers, in turn, may not be able to obtain the securities they want on behalf of investors, and thus may have to make sub-optimal investment decisions or may have to pay a liquidity premium. Issuers could also be negatively affected, with issuance ability and pricing related to the expected liquidity of the instrument.

Ultimately, a mandatory buy-in regime for non-CCP cleared transactions could negatively impact market liquidity and increase costs to end-investors. This could be especially the case in times of stress when markets become more volatile, and bid-offers and settlement failures increase. Furthermore, while negatively impacting all asset classes, these effects are likely to be disproportionately detrimental to less actively traded or illiquid securities, including instruments issued by SMEs, and high yield and emerging markets securities, which already suffer from lower liquidity and higher costs of trading.

The result is that a measure which was meant to improve settlement efficiency and stimulate European capital markets is likely to come at a high cost. We would therefore suggest replacing the mandatory buy-in regime for non-CCP cleared transactions with a discretionary one, while keeping a strong and robust penalty regime. Such an approach would significantly improve settlement efficiency in the EU and serve the ultimate goals of the CMU.