

Consultation Response

Technical Advice on CSDR Penalty Mechanism

February 2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on ESMA's consultation paper on technical advice on CSDR penalty mechanism. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

Executive Summary

AFME wish to reiterate our longstanding support of the CSDR Settlement Discipline and policymakers' ambition to reduce settlement fails in EU securities markets. We consider that the cash penalty mechanism is an appropriate tool for creating behavioural incentives towards settlement efficiency in EU securities markets.

We welcome ESMA's acknowledgement that targeting 100% settlement efficiency is not realistic, and share the aspiration set out in the CSDR Refit to achieve a long-term, continuous reduction in settlement fails. We note that, according to data collected by ESMA¹, the current penalty rates appear to have had a broadly positive impact on reducing settlement fails, in particular for equities. Fail rates in sovereign debt instruments, which represents over 50% of the total value of settlement instructions processed by EU CSDs, remain relatively low and stable. This marked and continuous improvement is also reflected in data from T2S, from CSD's public data and from AFME members, which suggests levels of settlement fails have more than halved since the introduction of cash penalties. Anecdotal feedback from AFME members further suggests that for non-centrally-cleared activity, levels of settlement fails in the EU are broadly comparable to other major jurisdictions such as the US and the UK.

Source	Start Period	End Period	Absolute Change ²	Relative Change ³
T2S	Q1 2022	Q3 2023	~ -3.0%	~ 46%
CSD public data	2022	2023	~ -4.0%	~ -58%
AFME Survey	Feb 2022	Dec 2023	~ -3.2%	<i>Not measured</i>

Given that all data indicates a material improvement in settlement efficiency, we do not believe there is an urgent need for a radical overhaul of the current penalty mechanism.

¹ https://www.esma.europa.eu/sites/default/files/2023-08/ESMA50-1389274163-2681_trv_2-23_risk_monitor.pdf

² Percentage point reduction in settlement fails between start period and end period

³ Relative reduction in settlement fails between start period and end period, as a percentage of the start period fail rate

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AFME members have established five well-established, foundational principles which we believe are critical to a successful cash penalties regime. We encourage authorities to consider any potential changes to the current penalty mechanism in this context.

1. Fairness / “immunisation principle”
As previously set out by ESMA during the initial design of the penalty mechanism, a party in the middle of a settlement chain with an offsetting failing purchase and delivery should receive an offsetting penalty credit and debit.
2. Simplicity and transparency
The mechanism should minimise complexity. It should be easily understandable for all types of market participants, allowing them to accurately predict net exposure and seeking to minimise the number of appeals or bilateral claims.
3. Proportionality
The cash penalties regime should create a behavioural incentive for market participants to prevent/remediate settlement fails – i.e. minimise their penalty debits. It should not create an incentive for market participants to seek to maximise their penalty credits, which will have distortive market impacts and undermine settlement efficiency. It should also not materially impact trading decisions/broader market liquidity.
4. Dynamic and flexible
The cash penalty mechanism should be a dynamic tool which allows authorities to react quickly to trends in settlement fails data by adjusting penalty rates as appropriate.
5. Part of a ‘toolkit’
The penalty regime should be supported by a broader regulatory framework that aims to improve settlement efficiency through promoting best practice and removing systemic barriers.

Proposals to significantly alter the methodology for calculating cash penalties – e.g. by varying daily penalty rates according to the length of the fail or notional value of the instruction – would undermine these principles, unnecessarily increasing the complexity of the regime whilst also introducing potential distortive impacts. Changes to the methodology would represent another significant multi-year implementation project for market infrastructures and their direct and indirect users. This would divert industry resources away from addressing underlying causes of settlement fails. It would also mean that by the time the changes took effect, the data on which the regulatory decision was made would be significantly out-of-date. If required, a recalibration of penalty rates within the current methodology could be implemented much more quickly.

We therefore strongly recommend that the basic methodology for calculating cash penalties is not changed.

We believe that a minor recalibration of the levels of penalty rates applicable to each asset class could be merited, taking into account a number of factors, including: the natural cost of failing – of which interest rates represent a significant component ; the systemic risk of the asset class; current settlement fail rates; and potential impacts of shortening the settlement cycle.

The proposal to drastically increase penalty rates, e.g. to between 6 to 25 times (Proposal 1) or 2.5 to 100 times (Proposal 2) current levels, does not seem to take into account the aforementioned factors. We believe that such an increase in penalty rates would be a significant overreaction by public authorities, and would cause material negative impacts to the liquidity and competitiveness of EU securities markets. This would be contrary to broader CMU objectives to encourage greater investment into and within the Union.

We call for public authorities to take a more proportionate and quantitative approach to recalibrating penalty rates.

As well as reviewing behavioural incentives towards settlement efficiency, further consideration should also be given to other changes to the regulatory framework which would support this objective. AFME recently published our report 'Improving the Settlement Efficiency Landscape in Europe'⁴, which identifies our members' perspective on the main causes of settlement fails and inefficiencies in post trade processes. The report sets out a number of recommended industry actions, emphasising our commitment to addressing current levels of settlement fails.

To this extent, some potential complementary measures could include:

- Reducing fails due to late-matching: improving the robustness of allocation and matching processes.. This should be supplemented by further developments to market practice (such as the use of common transaction identifiers, and increased use of industry platforms for storing and exchanging non-economic data.)
- Optimising settlement of available inventory: increasing the use of partial settlement by mandating that CSDs provide this functionality and market participants accept partial deliveries within certain parameters.

We strongly believe that further detailed analysis on root causes of settlement fails is required, noting that the divergence of settlement efficiency rates reported by CSDs points towards the existence of structural causes of settlement fails – i.e. those that will not be solved through increased penalties.

We therefore recommend that authorities also give appropriate consideration to other measures to support settlement efficiency objectives, outside of CSDR cash penalties.

⁴ https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_SettlementEfficiency2023_07%20final.pdf