

Reply Form

**to the Consultation Paper on Technical Advice on
CSDR Penalty Mechanism**



Responding to this Consultation Paper

ESMA invites comments on all matters in this Consultation Paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **29 February 2024**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

- Insert your responses to the questions in the Consultation Paper in this reply form.
- Please do not remove tags of the type < ESMA_QUESTION_CSDR_0>. Your response to each question has to be framed by the two tags corresponding to the question.
- If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.
- When you have drafted your responses, save the reply form according to the following convention: ESMA_CP1_CSDR _nameofrespondent.

For example, for a respondent named ABCD, the reply form would be saved with the following name: ESMA_CP1_CSDR _ABCD.

- Upload the Word reply form containing your responses to ESMA's website (**pdf documents will not be considered except for annexes**). All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading '[Data protection](#)'.

Who should read this paper?

All interested stakeholders are invited to respond to this consultation paper. In particular, ESMA invites market infrastructures (CSDs, CCPs, trading venues), their members and participants, other investment firms, credit institutions, issuers, fund managers, retail and wholesale investors, and their representatives to provide their views to the questions asked in this paper.

1 General information about respondent

Name of the company / organisation	European Banking Federation
Activity	Associations, professional bodies, industry representatives
Are you representing an association?	X <input type="checkbox"/>
Country / Region	Europe

2 Questions

Q1 Do you agree with ESMA's proposal? Which Option is preferable in your view? Please also state the reasons for your answer.

<ESMA_QUESTION_CSDR_1>

<ESMA_QUESTION_CSDR_1>

Q2 Do you have other suggestions? If yes, please specify and provide arguments.

<ESMA_QUESTION_CSDR_2>

<ESMA_QUESTION_CSDR_2>

Q3 Do you agree with the approach followed for the Option you support to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

<ESMA_QUESTION_CSDR_3>

<ESMA_QUESTION_CSDR_3>

Q4 What costs and benefits do you envisage related to the implementation of each Option? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_4>

Option		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<ESMA_QUESTION_CSDR_4>

Q5 As a CSD, do you face the issue of accumulation of reference data related to Late Matching Fail Penalties (LMFPs), that may degrade the functioning of the securities settlement system you operate? If yes, please provide details, including data where available, in particular regarding the number and value of late matching instructions, as well as for how many business days they go in

the past from the moment they are entered into the securities settlement system, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – June 2023).

<ESMA_QUESTION_CSDR_5>

<ESMA_QUESTION_CSDR_5>

Q6 What are the causes of late matching? How can you explain that there are so many late matching instructions? What measures could be envisaged in order to reduce the number of late matching instructions?

<ESMA_QUESTION_CSDR_6>

<ESMA_QUESTION_CSDR_6>

Q7 Do you agree with ESMA's proposal to establish a threshold beyond which more recent reference data shall be used for the calculation of the related cash penalties to prevent the degradation of the performance of the systems used by CSDs? Please also state the reasons for your answer.

<ESMA_QUESTION_CSDR_7>

<ESMA_QUESTION_CSDR_7>

Q8 Do you agree with the threshold of 92 business days or 40 business days in order to prevent the degradation of the performance of the systems used by CSDs? Please specify which threshold would be more relevant in your view:

a)92 business days;

b)40 business days;

c)other (please specify).

Please also state the reasons for your answer and provide data where available, in particular regarding the number and value of late matching instructions that

go beyond 92 business days, 40 business days in the past or another threshold you think would be more relevant, and the percentage they represent compared to the overall number and value of settlement fails on a monthly basis (please use as a reference the period June 2022 – December 2023).

<ESMA_QUESTION_CSDR_8>

<ESMA_QUESTION_CSDR_8>

Q9 Do you agree that the issuer CSD for each financial instrument shall be responsible for confirming the relevant reference data to be used for the related penalties calculation? Please also state the reasons for your answer.

<ESMA_QUESTION_CSDR_9>

<ESMA_QUESTION_CSDR_9>

Q10 In your view, where settlement instructions have been matched after the intended settlement date, and that intended settlement date is beyond the agreed number of business days in the past, the use of more recent reference data (last available data) for the calculation of the related cash penalties should be optional or compulsory? Please also state the reasons for your answer.

<ESMA_QUESTION_CSDR_10>

<ESMA_QUESTION_CSDR_10>

Q11 Do you have other suggestions? If yes, please specify, provide drafting suggestions and provide arguments including data where available.

<ESMA_QUESTION_CSDR_11>

<ESMA_QUESTION_CSDR_11>

Q12 Do you agree with the approach followed to incorporate proportionality in the Technical Advice? If not, please provide an indication of further proportionality considerations, detailed justifications and alternative wording as needed.

<ESMA_QUESTION_CSDR_12>

<ESMA_QUESTION_CSDR_12>

Q13 What costs and benefits do you envisage related to the implementation of the approach proposed by ESMA? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_13>

Approach proposed by ESMA		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<ESMA_QUESTION_CSDR_13>

Q14 If applicable (if you have suggested a different approach than the one proposed by ESMA), please specify the costs and benefits you envisage related to the implementation of the respective approach. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_14>

Approach proposed by respondent (if applicable)		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<ESMA_QUESTION_CSDR_14>

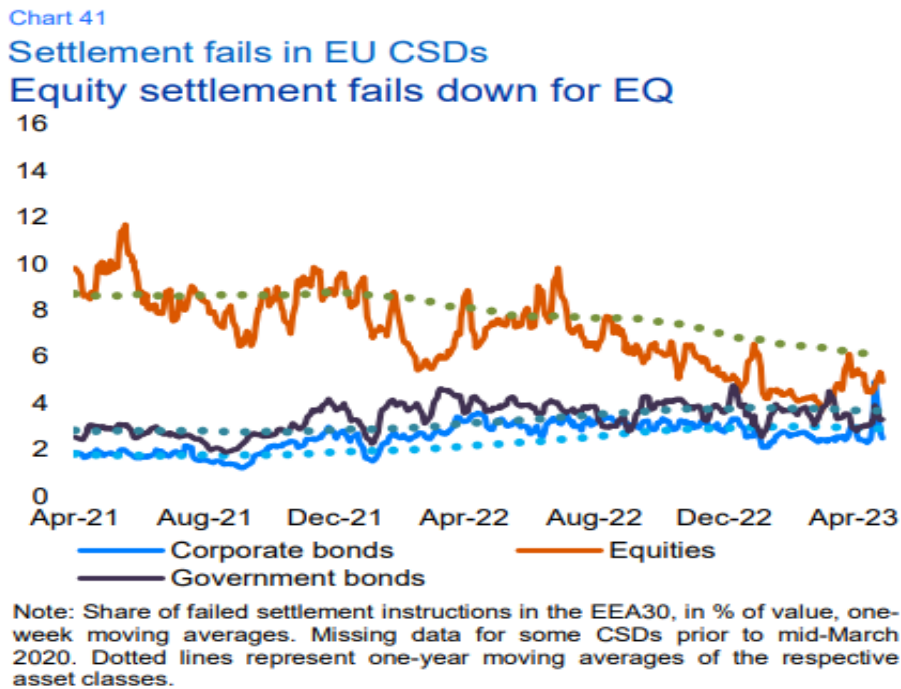
Q15 Based on your experience, what has been the impact of CSDR cash penalties on reducing settlement fails (by type of asset as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 since the application of the regime in February 2022? Please provide data and arguments to justify your answer.

<ESMA_QUESTION_CSDR_15>

Overall, based on data collected and published by ESMA (see graph below and following [link](#)), and internal calculations by Members, the EBF is of the view that, since its go-live phase launched in February 2022, the CSDR cash penalties mechanism has had a positive impact on settlement efficiency.

CSDR penalties, as well as complementary measures (like the working arrangements with relevant clients), significantly increased awareness of the importance of timely settlement, thereby attracting and focusing resources and investment to improve settlement efficiency and contributing to a reduction of the settlement fails.

At the same time, the reduction in the total number of penalties observed by Members especially the proportion of Late Matching Fail Penalty (LMFP), indicates a positive trend in overall penalty management.



Against this background, however, while a more noticeable effect can be registered on equities, the level of fail rates in government debt instruments, an asset class that represents over 50% of the total value of settlement instructions processed by EU CSDs, remain relatively low and stable. In this respect and, for the sake of clarify, it is however worth underlining that the new regime at issue did not prompt any deterioration in settlement efficiency rates in such specific asset class.

On a general level, while more can be done to improve certain ‘behavioural fails’ (as identified in the AFME report), one should note that there are structural issues to overcome in the region (which we explain in Q17).

For instance, ETFs instruments (and subsequently those participants significantly active in the ETF business) continue to show comparably low settlement efficiency levels due to the currently complex processes.

Having said that, EBF Members generally believe that many of the basic features of the penalty mechanism are well-designed, as they create financial incentives for timely settlement.

Data quality:

It is also worth noting that the methodology used to assess and count settlement fails has changed with the CSD’s reporting obligations under CSDR Level 2 Art.14 which makes it difficult to compare settlement efficiency pre and post the introduction of the cash penalty

regime. Better comparability of settlement efficiency indicators would also be achieved through more granularity of data on additional criteria, such as breakdowns by age of settlement fails, instrument type, transaction type, fail reason codes, asset class, matching time, etc. (please refer to AFME paper on “Provision of Public Data to Support Settlement Efficiency Objectives”, dated Nov 2022).

Similarly the ESMA TRV reporting methodology has recently changed with the Q4 2023 analysis now aligning with the CSD’s reporting as determined under RTS Art.14 rather than the methodology previously used by ESMA in these reports. This level of inconsistency means that there is no foundation to assess settlement efficiency pre and post the introduction of the cash penalty regime on 1st Feb 2022 and no basis to identify if and in what circumstances cash penalties should be increased. Furthermore, the different reporting parameters used by ESMA draw very different conclusions which results in ambiguity of the actual level of settlement fails. The EBF recommends that a full review of data quality and the methodology used to define and report settlement fails is effected, concluded, implemented and observed prior to any change to the cash penalty regime.

Need for an adequate observation period:

ESMA note in point 45 of the consultation paper there needs to be a longer observation period and to allow sufficient time to ensure the adequate level of data quality:

45. Given the need to have a longer observation period since the start of the application of cash penalties to have a meaningful assessment of the impact of cash penalties on settlement efficiency, as well as to allow for sufficient time to ensure an adequate level of data quality regarding the settlement fails reports submitted under Article 7(1) of CSDR, ESMA aims to publish a more detailed impact analysis at a later stage.

The EBF believes this to be foundational. There needs to be good data, adequate granularity, a single and robust methodology and sufficient time once the data quality issues have been corrected to assess settlement efficiency. Increasing the cash penalty rate without having effective and reliable foundations will not fix the issues and cause damage to the regions securities markets.

<ESMA_QUESTION_CSDR_15>

Q16 In your view, is the current CSDR penalty mechanism deterrent and proportionate? Does it effectively discourage settlement fails and incentivise their rapid resolution? Please provide data and arguments to justify your answer.

<ESMA_QUESTION_CSDR_16>

The EBF emphasizes that the current CSDR penalty mechanism is deterrent and proportionate, and it does discourage settlement fails and incentivises timely settlement. On this point, the reduction in settlement fails are a testament to the focus and investment that market participants have made in the preparations to the introduction of the regime and post its implementation (per the graphs we include in Q15).

Against this background, **the EBF is of the view that further improvements to increase the effectiveness of the penalty mechanisms are possible through an appropriate and proportionate re-calibration of penalty rates.** Other options, such as substantial changes to the overall functioning of the framework, or disproportionate/massive increases in penalty rates, would - introduce further complexity, and increase the risk of material knock-on effects while not being conducive to higher settlement efficiency rates.

Therefore, we would like to include the **specific commentary** below:

- With regards to **proportionality** there are a number of considerations. The majority of fails owing to operational inefficiency, whether that be 'behavioural issues' of market participants or structural issues at the level of the CSDs in respect of x-CSD settlement or DVP vs FOP cut-off differences, are generally resolved in the first 1 or 2 days post ISD i.e. achieving the 'rapid resolution'.
- Whilst market participants' operational inefficiency should be penalised (i.e. late: bookings / allocations / confirmations / instructions, lack of proactive realignments), **it is not proportionate for market participants to be penalised fail due to misaligned CSD batch times or lack of CSD functionality** or due to a borrow that comes in after DVP close owing to the later FOP batch time.
- **Likewise it is not proportionate for settlement instructions to be penalised twice.** As AFME notes in its Settlement Efficiency paper, there are scenarios where the cash penalty regime serves as a disincentive for trading parties to resolve settlement fails such as agreeing to partial. Where auto-partial is not possible (e.g. where the CSD does not support it or does not offer partial release) both parties will need to 'manual partial' which means cancelling and re-instructing the two new settlement instructions. Since partial settlement takes place on ISD+ it will mean that previously matched but failing instructions that are re-instructed will incur 'late matching fail penalties' for whichever party is last to input the new instructions. Whilst ESMA guidance explicitly states that CSDR "should not lead to the application of duplicative penalties for the same settlement instructions on the period between the ISD and the date of the introduction of the new settlement instruction into the securities settlement system" there currently appears to be no systematic means for CSDs to identify and exclude

such instructions from the application of penalties. Such a barrier serves as a disincentive to reduce settlement risk and optimise available inventory.

- The cash penalty regime can also can discourage trading parties from wanting to rebook their settlement instruction to resolve a mis-match, at least without agreement that the penalty amount can be reclaimed from their counterparty. This leads to delays and inefficiencies in the settlement process that again are detrimental to the objective of reducing settlement risk and achieving settlement efficiency.
- Any fails after ISD+2 or ISD+3 will likely be due to scarcity of the instrument or more fundamental reasons outside a participants direct control. The cash penalty regime is calibrated around the liquidity of the financial instruments in scope of the regime. A proportionate regime should reduce risk without reducing market liquidity which would be detrimental to investors and would impact the ability to borrow to cover shorts or fails which would negatively impact settlement efficiency. ‘

Care needs to be taken on revising the cash penalty rates for illiquid instruments for which scarcity rather than operational error will be the likely reason for fails after ISD+3.

Finally, in order to improve settlement efficiency, the EBF emphasizes that measures other than the proportionate recalibration of penalty rates should be considered.

Notably, use of partial settlement and partial release (see answer to question 18 below) is key and must be substantially incentivised. On this, The EBF refers to further discussion and analysis, and remains open to supporting the exploration of workable and effective options that would allow for a material encouragement to use partial settlement and partial release along the settlement chain.

Nonetheless, one guiding principle that the EBF underlines is that the penalty regime should not become more complex (e.g. by introducing progressive or a minimum penalty fee), introduce disproportionate knock-on effects, or break immunisation as underpinned by current CSDR rules.

<ESMA_QUESTION_CSDR_16>

Q17 What are the main reasons for settlement fails, going beyond the high level categories: “fail to deliver securities”, “fail to deliver cash” or “settlement instructions on hold”? Please provide examples and data, as well as arguments to justify your answer.

<ESMA_QUESTION_CSDR_17>

It is helpful to divide the reasons for settlement fails into three four main categories, based on the lifecycle of a securities settlement instruction:

1/ Late instructions i.e. reasons that result in settlement instructions arriving late at the CSD

Clients of custodians i.e. the trading parties may instruct late due to the following reasons:

- OTC trade booked late by trader
- Late allocation by Investment Manager results in late booking by the broker (and late confirmation). Similarly, late confirmation by the broker leads to late instruction by the Investment Manager.
- Missing reference data required for booking a trade such as:
- ISIN not set up by the data provider or ISIN not set up at the CSD results in the settlement instruction being rejected
- Client account not opened in time or missing the data required to generate and flow settlement instructions such as SSIs
- Settlement instruction template not set up in time
- System issues
- The client may be in a different time-zone and instruct the custodian in their operating hours rather than the operating hours of the CSD resulting in late instructions

Custodians transmit their clients instruction through to the CSD but are constrained by cut-off times dictated by the CSD. If a client sends their instruction late in the day close to the CSD deadline the custodian can only turn these instructions around on a 'best efforts basis'. It is important to note, that whilst a custodian will typically 'turn around' their client's instruction in quick order they do have to allow sufficient time to validate the instruction's format / eligibility, perform sanction screening and credit checks (where appropriate) before sending to the CSD There may be situations where a custodian instructs late due to their own data quality or system issues.

2/ Matching problems i.e. reasons that result in settlement instructions failing to match at the CSD

Matching issues at the CSD typically fail into 2 categories as follows:

- Economic mismatches such as differences such as ISIN, nominal, value date, cash amount due to lack of timely / accurate data, workflow management issues. Incorrect holiday calendars can create value date mismatches. Lack of clarity whether an instrument should be settled as a unit or nominal can create issues also.

The data / systems and operational teams who support 'trade level matching i.e. the allocation / confirmation matching and broker matching' can be different to the teams / operational systems used to support 'settlement matching'.

In addition the cash tolerance used for matching in vendor matching platforms might not confirm to the tolerances used at the CSD's under CSDR RTS Article 6.

- Non-economic mismatches due to different standard settlement instructions (SSIs) or place of settlement (PSET) due to data quality issues, lack of market standards and different matching conventions in vendor matching platforms. PSET is not a matching field in vendor platforms and should be.

Please note that ownership and responsibility for the economic and non-economic information included in the settlement instructions lies with the custodians' clients. Custodians transmit their client's instructions through to the CSD and are unable to amend without a new instruction from the client.

3/ Structural issues i.e. matters out of the direct control of custodians and their clients (the trading parties)

Despite strides having been made to reduce the barriers to post trade integration in the region there are still a number of barriers that exist that challenge timely settlement. At a high-level these issues include:

Lack of harmonised CSD standards / practices:

- Misaligned: batch times, instruction input and / or settlement cycle cut-offs including misalignment between DVP and FOP batch times which result in fails / inventory not being maximised
- Derogation for certain CSDs under CSDR to not have to offer partial settlement and hold & release
- Partial release not offered by all CSDs which is an essential tool for partial settlement to be used in omnibus accounts

- Differing use and acceptance of ISO transaction types in settlement instruction messages results in settlement instructions being rejected at the CSD's SWIFT gateway
- Differing SWIFT message templates used by CSDs including different formats for cross-border settlement creates a myriad of templates required to settle instructions in EEA CSDs
- Lack of instrument interoperability - certain ISINs are not eligible to settle in every EU CSD

Other barriers:

- Different CCP cut-offs
- Market liquidity constraints

3/ 4/ Lack of resources i.e. reasons for a party having insufficient resources (securities or cash) to settle a trade.

As cash in a single currency is fungible, settlement fails resulting from a lack of cash are very short-lived, and in most cases are resolved during the same settlement day.

Within category 3/, most settlement fails derive from a lack of securities, as securities, represented by different ISINs, are not fungible.

Settlement fails deriving from a lack of securities can be categorised into three subcategories:

- (i) Problems deriving from a lack of pooling (i.e. from split positions). In such a case, the trading party has sufficient securities, but the securities are not immediately available for settlement, as they are located in a different place due to the position being purchased from different sources (exchange / MTF / another broker) and in multiple shapes meaning the receipts will not always correspond to the client deliveries hence creating the need for partial settlement.
- (ii) Problems associated with failing receipts (i.e. a chain of failing transactions). In such a case, the trading party has arranged to have sufficient securities in order to settle a delivery, but has not yet received those securities or per the above point will purchase the position in various shapes from various sources (including the CCPs) and as such may not have the full position available to deliver but will be able to deliver partials.

- (iii) Problems associated with a real shortage of securities. In such a case, the trading party has not yet arranged to have sufficient securities in order to settle a delivery due to the instrument lacking liquidity which may mean that the ‘cover position’, which are often sourced via a borrow / repo, is failing (link to failing receipts in point ii above – the failing settlement chain of matched fails. Please refer to Q16 where ‘scarcity of the instrument is detailed’. Please refer to our comments in Q16

In this context, we do want to highlight the following points:

- Within each of the categories, and each of the sub-categories, there may be many diverse underlying root causes for settlement fails.
- A single settlement failure (falling into subcategory (i) or (iii)) in a chain of transactions may well lead to multiple settlement fails (falling into subcategory (ii)).

<ESMA_QUESTION_CSDR_17>

Q18 What tools should be used in order to improve settlement efficiency? Please provide examples and data, as well as arguments to justify your answer.

<ESMA_QUESTION_CSDR_18>

As mentioned in our answer to Question 17, settlement fails may have very diverse and multiple underlying root causes.

One major benefit of the current CSDR penalty mechanism for improving settlement efficiency is that it is an overarching tool that provides incentives for improved behaviour. Considered the positive impact registered so far, we believe that no comprehensive reorganisation of the penalty regime is required or necessary. As far as improvements in settlement efficiency attainable by changes in behaviour, therefore, a moderate and linear re-calibration of the penalty rates applicable to settlement fails would be sufficient, if considered appropriate and proportionate. A key precondition is that the system remains as simple as possible.

Any change to the existing system would be very costly for everyone involved. It is not clear why a completely new method should be better than a linear modification of the existing calculation. All market participants would then be forced to extensively rebuild their systems. Against the background of a cost-benefit analysis, this is questionable. We also believe that a system that is too complex would make European capital markets more unattractive in comparison to other jurisdictions.

Having said that, however, one must emphasize that the CSDR penalty mechanism cannot resolve fails attributable to structural or liquidity issues.

Against this background, we believe that the current CSDR penalty mechanism should be complemented by other more specific, and more targeted, tools and actions, which may require changes to FMI, regulation and messaging, to improve the operating environment and further enable timely settlement.

The EBF supports the analysis and recommendations produced by AFME in their whitepaper 'Improving the settlement efficiency landscape in Europe'. From a custodians point of view sitting between the trading parties and the CSDs the following areas of focus will be beneficial to achieving greater settlement efficiency discipline:

In order to tackle settlement fails arising from **late instructions and from matching problems**, there is a need for improvements to:

- Allocation & Confirmation processes: ensure that timing and processing aligns with CSDR RTS Article 2 and to ensure that the pre-settlement matching criteria aligns to the CSD matching criteria this will avoid undue latency and exceptions in downstream processes such as settlement instruction and CSD level matching.
- Reference Data: ensure that reference data is set up ahead of trading:
- Client accounts to be set-up and include all pertinent data required to book / allocate a trade and send settlement instructions.
- SSIs: make use of SSI repositories to automate the use and population of SSIs to avoid manual templates and call-backs.
- ISINs: to be set up by trading parties ahead of trading to prevent booking issues. CSDs and custodians to set up ISINs to ensure that settlement instructions can be sent and accepted without rejection.
- Review of standardised settlement instruction templates without optional fields to create a single standard for each CSD / X-Border CSD relationship .
- Holiday calendars to be shared by CSDs and set-up in trading party and custodian systems ahead of the next calendar year.
- Vendor matching platforms to match to the same standards as the CSDs to avoid 'false matches' and pushing the identification and resolution of issues down to the 'settlement

matching' level at the CSD. AFME is currently working with vendors to improve 'upstream' pre-settlement matching processes – the EBF supports these efforts.

- It is important for settlement instructions to be sent real-time / intra-day, or at least as soon as possible, rather than in batches to ensure that instructions are cascaded through to the CSD on trade date so that matching discrepancies are visible to trading parties via their custodians as early as possible. The use of 'on hold' should be leveraged by custodians and other CSD participants to enable matching and the early identification of exceptions without committing the instruction to settlement (until cash / securities are in place).

In order to tackle **structural issues**:

- We direct ESMA to the work currently being conducted by the ECB Ami-SeCo on identifying the remaining barriers to post trade integration, findings by ESCDA and AFME for example are publicly disclosed.
- We also welcome the removal of CSD derogations for partial settlement and hold and release during the re-drafting of the CSDR RTS on Settlement Discipline. We also welcome the introduction of mandatory offering of partial release through the same re-drafting to ensure that auto-partialling can be used in omnibus accounts.
- At a CSD level a review is required to ensure that all CSDs are meeting the requirements of Article 5 of the CSDR RTS, which requires CSDs to "provide to participants a functionality that supports fully automated, continuous real-time matching of settlement instructions throughout each business day."
- CSD cycles and market cut-offs should be widely aligned, including partial settlement cycles which currently differ substantially, and a simplified and harmonised process for realignment of assets between CSDs should be established. This helps to optimise settlement of available inventory, reduce settlement fails and the associated costs of cash penalties, capital charges and additional funding costs.
- Proposal: Increase use of partial settlement and partial release
- Making partial settlement mandatory could effectively counteract the increase in fails that is may occur as a consequence of a compressed settlement cycle. As a matter of fact, the optionality provided for by the CSDR regulatory framework when it comes to **partial settlement may be seen as having diminished, so far, the degree of effectiveness of this measure.** On this, The EBF refers to further discussion and analysis, and remains open to supporting the exploration of workable and effective options that would

allow for a material encouragement to use partial settlement and partial release along the settlement chain.

- From an operational standpoint, it must be underlined that the increased use of partial release plays a decisive role: indeed, partial settlement “per se” risks being not sufficient since merely keeping “in hold” the instructions does not automatically prompt an increase in settlement in percentage terms. Moreover, it is also worth underlining that the procedures governing the way the “Hold” is managed cannot and should not be modified as far as “third-parties” are concerned since this would otherwise i) prompt an increase of the so-called “drawing from the mass” or ii) raise the need to open segregated accounts and, in the final analysis, iii) drive upwards the costs for participants.
- From a regulatory standpoint, the above-mentioned recommendation would turn into a deletion of Article 12 of the Regulatory Technical Standards on CSDR settlement discipline (Commission Delegated Regulation (EU) 2018/1229), which provides for a derogation for certain CSDs from the requirements to provide a partial settlement and hold and release mechanism.
- That said, we would like also to stress the need that such a regulatory change should be designed and implemented with care and caution: namely, partial settlement could be made mandatory i) for the main asset classes ii) but not, for example, for stock lending. Moreover, specific types of instructions such as, for example, portfolio transfers as well as new issuances, “mark-up/mark-downs” and claims/transformations should be excluded from partial settlement.’

In order to tackle settlement fails resulting from a lack of **lack of resources**:

- Increased CSD interoperability and standardisation to achieve a single market and enable the seamless flow of securities cross-border
- Proactive realignment to ensure positions traded into CSD A are available in CSD B / C etc where required
- Shaping and splitting to align the nominals of deliveries to the nominals of the receipts.
- Further to the requirements for all CSDs in the region to provide all functionality required for partial settlement, market standards are required for CSD participants and their clients to support and use partial settlement.

However, processes that are performed prior that settlement instructions are sent to the CSD should also be assessed by the relevant stakeholders to complete the picture and address issues that already occur much earlier, e.g. on trading level.

<ESMA_QUESTION_CSDR_18>

Q19 What are your views on the appropriate level(s) of settlement efficiency at CSD/SSS level, as well as by asset type? Please provide data and arguments to justify your answer.

<ESMA_QUESTION_CSDR_19>

The original purpose of the introduction of the penalty regime was to increase market stability and reduce risk in the settlement system by seeing a sustainable improvement in settlement discipline. To a large extent, we feel that this has been achieved by the market through the adoption of new technologies and increased automated processes by market participants, as well as increased focus on resolving the root causes of fails.

With relation to the appropriate level of settlement efficiency, our starting position is that this is a near impossible question to answer. Everything else being equal – a higher rate of settlement efficiency is better than a lower rate.

As set out in our answers to questions 16, 17 and 18, we believe that there is scope to improve settlement efficiency in Europe.

Yet, at the same time, we do not believe that public authorities should set out explicit targets for settlement efficiency.

ESMA themselves note that not all fails are equal and that achieving 100% settlement efficiency is not possible. This is because settlement efficiency rates are dependent on a whole series of factors, many of which are external to individual capital market participants, and because any explicit settlement efficiency targets may have perverse effects.

Settlement efficiency rates are affected by such factors as:

- CSD functionalities
- CSD daily timetables (period of time a CSD is open for settlement)
- Liquidity of a security

- Increased participation in capital markets by issuers and investors (as new types of issuer will tend to issue less liquid securities, and new types of investor will have lower average volumes and will tend to be less automated)
- External shocks

In the event of a significant external shock to the European financial system, it is important that markets remain liquid, and that trading continues, even though the shock reduces overall rates of settlement efficiency. An explicit settlement efficiency target for market participants could dissuade market participants from continuing to trade and would thereby reduce the resilience and shock absorption capabilities of the financial system as a whole.

Rather than setting explicit targets for settlement efficiency, we believe that public policy action should focus on:

- improving the functioning of the markets and of market infrastructure; and
- creating an overarching framework to incentivise improvements to settlement efficiency.
- Enhancing the quality of data on settlement efficiency and fail rate KPIs that are publicly available, for a more granular analysis of the most relevant operational and structural problem areas (by market, by asset class, by transaction type, by ageing, etc., as also described in our answers to Q15 and Q21).
- Promote a clear understanding of “when” high levels of settlement fails start representing a source of systemic risk for the EU. Should this approach be pursued by EU policy-makers, it should be based on rigorous and comprehensive factual and empirical evidence.
- Plurality of levels of settlement efficiency: having different optimal levels of settlement efficiency according to each asset type could be considered. To that aim, a series of factors should be considered e.g. i) trading volume ii) market value iii) liquidity etc.

<ESMA_QUESTION_CSDR_19>

Q20 Do you think the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389 are proportionate? Please provide data and arguments to justify your answer.

<ESMA_QUESTION_CSDR_20>

Further to our response to Question 16, **the EBF considers the existing regime to be adequate**. Also, it is still a relatively new regime; one which was introduced with some notable headwinds such as market volatility, early ‘teething issues’ that lasted some 6 months (some issues remain today), and a lack of measurement due to the differing data and reporting methodologies used.

Therefore, in weighing up what a proportionate regime should look like, **it is essential that the cash penalty rate is proportionate to the root cause of the settlement fail** and per ESMA’s own deduction and per our responses to the preceding questions ‘not all fails are equal’.

For example, **it is particularly not appropriate or proportionate to increase the cash penalty rate for instruments with a lack in liquidity**, as this will add to the strain on the issue.

Similarly, **it is not appropriate or proportionate to increase penalty rates for fails that are a direct consequence to the structural issues in the region that impede timely settlement**.

As identified in the September 2023 Settlement Efficiency hosted by ESMA, there is still much work to do be done across the industry and regulatory community to: i) identify the root cause of settlement fails and implement solutions which will require changes to regulation, CSD operations in addition to market participants own operations and ii) ensuring an appropriate data and reporting methodology that accurately captures settlement fails and does not inflate the numbers by ‘double counting’.

Against this background, **the EBF strongly emphasizes that any changes to the cash penalty methodology including the introduction of progressive penalty rates will be a significant and costly undertaking for CSDs, as well as to the wider industry, including custodians**. It will require substantial changes to the CSD’s cash penalty process. Thorough end-to-end testing will also be required prior to deployment. The need for testing is essential to avoid any detrimental impact to the CSDs operating environment and to ensure that the daily and monthly cash penalty calculation and reporting processes are seamless. Lessons should be learned from the 1st February 2022 implementation. Furthermore, any changes to CSD systems will come at a cost which will be passed onto CSD participants adding to the regions high cost profile.

Furthermore, in case a review exercise starts and introduces complexities, these will have to be implemented in the upcoming years, generating further constraints for market participants who will have to address the challenges associated to a potential EU move to T+1.

All things considered, on this point, we would warn against both the introduction of substantial complexity and any potential disproportionate, non-linear increase in settlement penalty rates

to take place before the potential EU shift to T+1. In this respect, it is worth underlining what follows:

- At this stage, market participants have to cope with the complexities generated by the US move to T+1 e.g. those related to the treatment of so-called “dual listed” securities
- Moreover, as preliminary step should an EU move to T+1 be decided, it would be of key, fundamental importance to first create the appropriate pre-conditions and improve the status quo and, in particular, some settlement practices based on the regime currently in force. In this respect, and by way of an example, we are witnessing an increase of erroneous calculation of penalties among CSDs (thereby “forcing” parties to “settle” this).

<ESMA_QUESTION_CSDR_20>

Q21 Regarding the proportionality of the penalty rates by asset type as foreseen in the Annex to Commission Delegated Regulation (EU) 2017/389, ESMA does not have data on the breakdown of cash penalties (by number and value) applied by CSDs by asset type. Therefore, ESMA would like to use this CP to ask for data from all EEA CSDs on this breakdown, including on the duration of settlement fails by asset type.

<ESMA_QUESTION_CSDR_21>

<ESMA_QUESTION_CSDR_21>

Q22 In your view, would progressive penalty rates that increase with the length of the settlement fail be justified? Please provide examples and data, as well as arguments to justify your answer.

<ESMA_QUESTION_CSDR_22>

We do not believe that progressive penalty rates are justified. If introduced, we believe that they will have counterproductive and even yield perverse knock-on effects.

Progressive penalty will damage many of the principles that lie at the heart of the design of the current CSDR penalty mechanism.

These principles are simplicity, transparency, auditability, fairness, as well as immunisation and operational efficiency.

For the mechanism to work correctly, penalties have to be transmitted down the custody chain to the party that is apparently at fault. Each party in the chain down to the end investor has to be able to recognise and understand both the source and the applicability of each penalty.

Progressive penalty rates create complexity and will make it more difficult for parties in the chain to recognise and to understand individual penalties. Notably, they would require significant IT developments (including testing) for any EU/ EEA CSDs, T2S and participants and would make the application of penalty rates for transactions failing for more than one day (and including late matching fails) much more complex.

We also note that the term “Day” used in the ESMA table “Option 1” (page 35) as well as in the “Option 2 - Example 2” on pages 56, 57 should be clarified and understood as “Business day”, not “Calendar day”.

Notably, progressive penalty rates will damage the immunisation principle, whereby a party in the middle of a chain of failing settlement instructions is “immunised”, as the penalty amount that the party pays is compensated by the penalty amount that the party receives.

As transactions may be instructed and matched on different days, and as failing settlement chains are “dynamic” and may change over time as new instructions are matched, and other transactions settle, there is no guarantee with progressive penalty rates that the penalty rate on a receipt will be the same as the penalty rate on a delivery.

This in itself will generate anomalies, as parties not at fault will be hit with net penalties.

The immunisation principle is also important to reduce the risk of double borrowing – same argument as for multiple buy-ins in a chain of failing transactions.

Knock-on effects:

- 1) progressive penalties for late settlement fines create an incentive for parties not to send settlement instructions until they have the securities available, as the late matching fines would be lower.
- 2) increasing the complexity, and reducing the attractiveness, of European capital markets.
- 3) progressive penalties will increase the number of bilateral claims.

It is also important to note that the majority of fails are resolved on ISD+1 and +2 with only a small percentage of trades failing past 3 days.

Progressive penalty rates are not justified as market participants are already incentivised to avoid failing, both on the receive and delivery sides.

In the presence of unavoidable fails due to structural or liquidity issues, progressive penalty rates will be unlikely to resolve the fail any quicker. On the contrary, they will add more stress to the system and more cost, which will impact the EU securities markets.

In the end, we believe that regulatory initiatives at the EU level should strive for prompting more stability in the settlement space and not additional complexity.

<ESMA_QUESTION_CSDR_22>

Q23 What are your views regarding the introduction of convexity in penalty rates as per the ESMA proposed Option 2 (settlement fails caused by a lack of liquid financial instruments)? Please justify your answer by providing quantitative examples and data if possible.

<ESMA_QUESTION_CSDR_23>

We advocate for straightforward penalty rates.

Our position is grounded in the belief that introducing unnecessary complexities to the rule framework does not yield significant benefits. A streamlined and easily understandable penalty system is essential for effective communication, comprehension, and adherence by market participants. Clear and simple rules facilitate transparency and help avoid potential misinterpretations or disputes, ensuring that the penalty mechanism serves its intended purpose without unnecessary intricacies.

Focusing solely on liquidity when calculating penalties would represent a significant change compared to the current approach. The cost/ benefit ratio is too low to justify any change that will require relevant IT developments (including testing) for any EU/ EEA CSDs, T2S and participants and would make the application of penalty rates much more complex for transactions failing for more than one day (and including late matching fails).

<ESMA_QUESTION_CSDR_23>

Q24 Would it be appropriate to apply the convexity criterion to settlement fails due to a lack of illiquid financial instruments as well? Please justify your answer by providing quantitative examples and data if possible.

<ESMA_QUESTION_CSDR_24>

Consistently with our answers to questions 22 and 23 above, the application of a convexity criterion is highly questionable, irrespective of the asset class considered.

That said, the protection of liquidity in less-liquid instruments should be considered with particular attention when considering any potential change to the penalty regime.

<ESMA_QUESTION_CSDR_24>

Q25 What are your views regarding the level of progressive penalty rates:

a) as proposed under Option 1?

b) as proposed under Option 2?

<ESMA_QUESTION_CSDR_25>

As set out in our previous answers, and in particular in our answer to question 22, we believe that introducing progressive penalties will be damaging.

The penalty rates set out in Options 1 and 2 are not simply progressive. They also represent major increases in overall penalty rates and significant increases in the complexity and operational costs of running the penalty regime for all intermediaries in the custody chain. They would also fail to quickly and easily improve settlement efficiency targets.

Although we support the principle of a recalibration of penalties in order to contribute to creating appropriate incentives for timely settlement, we have major concerns about the size of the increases set out in Options 1 and 2.

Some considerations:

1/ In many cases, there already are incentives for market participants to settle on a timely basis – the cash resulting from settlement of a DVP, capital savings on pending transactions, and the operational burden of monitoring and managing fails.

2/ A major increase in penalties creates the risk of unforeseen effects – through, for example, the impact on trading activities, and a potential diversion of activity from central market infrastructure because of the cost, risk and uncertainty generated by the penalty mechanism.

3/ One critical point is that the penalty mechanism of CSDs does not have full information as to the precise causes of a settlement fail. Accordingly, for an individual transaction, it may well impose the penalty on the innocent party. This is not in itself not necessarily a problem. If the absolute size of an individual penalty is low, then the individual penalty itself may not matter much, and the penalty mechanism will achieve its effect through the collective impact of penalties on a pattern of activity. And, of course, any innocent party can correct the penalty mechanism by making a bilateral claim against its counterparty, or against the party at fault. But a major increase in penalty size creates additional burdens and risk, through the increase in bilateral claims, and through the imposition of large penalties on parties that may be innocent.

4/ The fundamental rationale for the penalty mechanism is that it is a mechanism to deal with externalities (as there are costs associated with failing settlement, so that it is appropriate for a party with bad behaviour to compensate a party with good behaviour). Major increases in penalty rates (going beyond the compensation of external costs) will distort the market, as it will benefit some categories of market participants, other others.

5/ Pursuant to recital 16 of CSDR, penalties should be configured in a way that “maintains and protects the liquidity of the relevant financial instruments. In particular, market-making activities play a crucial role in providing liquidity to markets within the Union, particularly to less liquid securities. Measures to prevent and address settlement fails should be balanced against the need to maintain and protect liquidity in those securities.”

The above-mentioned principle risks being jeopardized by the levels of penalty rates proposed by ESMA and this could, on its turn, hurt i) liquidity and, in the final analysis, ii) the competitiveness of EU securities markets

For the sake of clarity we note that already today ETFs (category “ETFS”) are penalized in the same way as the categories “SECU”, “UCIT”, “EMAL” and “other” instruments (per fail day, 0.50/ 0.25 bp’s apply) and we see no obvious reason why a new category for ETFs should be added.

<ESMA_QUESTION_CSDR_25>

Q26 If you disagree with ESMA’s proposal regarding the penalty rates, please specify which rates you believe would be more appropriate (i.e. deterrent and proportionate, with the potential to effectively discourage settlement fails, incentivise their rapid resolution and improve settlement efficiency). Please provide examples and data, as well as arguments to justify your answer. If

relevant, please provide an indication of further proportionality considerations, detailed justifications and alternative proposals as needed.

<ESMA_QUESTION_CSDR_26>

We strongly favour to keep the current system while considering a slight/moderate linear general recalibration of the penalty rates. The current set-up is in place for only two years and has already shown positive effects.

Implementing changes to penalty rate categories may necessitate adjustments to various technical aspects, such as interfaces and reporting presentations throughout the entire settlement process chain. We would like to question whether the efforts and costs involved in these technical adaptations would be justified in terms of the overall benefits gained.

Therefore, our inclination is to prioritize a comprehensive evaluation of generally higher penalty rates before considering additional adjustments that may introduce complexities and raise questions about their cost-effectiveness.

Notably, any potential recalibration of current penalty rates should be based on accurate, comprehensive and granular data.

When considering potential recalibration, the following list of factors (preliminary and not exhaustive) could be considered:

1. Interest rates

Rationale: higher interest rates create an additional cost/disincentive to fails to deliver.

2. Ability to use securities lending market and associated costs, duration and availability .of borrowing securities

3. Broader market conditions

Rationale: as shown in March 2020, periods of volatility/market stress are likely to prompt an increase in settlement fail rates. There is the risk that higher penalty rates may further heighten rather than mitigate tensions in the settlement value chain.

4. Move to a shorter settlement cycle

Rationale: a move, for example, to T+1 could prompt an increase in settlement fails rates for the mere reason, all things being equal, that market participants would have less time to resolve operational issues and place cash/securities ready for settlement.

<ESMA_QUESTION_CSDR_26>

Q27 What are your views regarding the categorisation of types of fails:

a) as proposed under Option 1?

b) as proposed under Option 2?

Do you believe that less/further granularity is needed in terms of the types of fails (asset classes) subject to cash penalties? Please justify your answer by providing quantitative examples and data if possible.

<ESMA_QUESTION_CSDR_27>

The two suggested options would represent a significant change compared to the current penalties calculation approach. The cost/benefit ratio is too low to justify any change that will require relevant IT developments (including testing) for any EU/ EEA CSDs, T2S and participants and would make the application of penalty rates much more complex for transactions failing for more than one day (and including late matching fails).

Please also refer to our answer to Q 26

<ESMA_QUESTION_CSDR_27>

Q28 What costs and benefits do you envisage related to the implementation of progressive penalty rates by asset type (according to ESMA's proposed Options 1 and 2)? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_28>

Progressive penalty rates (by asset type) - ESMA's proposal Option 1	Please see ESMA's proposed Option 1 in Section 5.3 of this CP.	
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Progressive penalty rates (by asset type) - ESMA's proposal Option 2	Please see ESMA's proposed Option 2 in Section 5.3 of this CP.	
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

The EBF advises against the introduction of progressive penalty rates.

The two suggested options would represent a significant change compared to the current penalties calculation approach. Their implementation would raise substantial complexities. The cost/ benefit ratio is too low to justify any change that will require relevant IT developments (including testing) for any EU/ EEA CSDs, T2S and participants and would make the application of penalty rates much more complex for transactions failing for more than one day (and including late matching fails).

Please also refer to our answer under Q 26 and 27.

<ESMA_QUESTION_CSDR_28>

Q29 Alternatively, do you think that progressive cash penalties rates should take into account a different breakdown than the one included in ESMA’s proposal above for any or all of the following categories:

- (a) asset type;
- (b) liquidity of the financial instrument;
- (c) type of transaction;
- (d) duration of the settlement fail.

If you have answered yes to the question above, what costs and benefits do you envisage related to the implementation of progressive penalty rates according to your proposal? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_29>

The EBF questions the introduction of progressive penalty rates. As indicated above, we believe that regulatory initiatives at the EU level should strive for prompting more stability in the settlement space and not additional complexity.

Note: transaction type is not a matching criteria for settlement transactions, hence, the information could deviate between the securities delivery and receipt leg of a transaction

In addition, since chains of settlement are not made of instructions that relate to the same type of transaction, this will breach the immunisation principle. For example: a recall because of a sale on the market. If they both fail, penalties should be equal so that at the end the participant is not penalised.

Progressive penalty rates – respondent's proposal <i>(if applicable)</i>		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<ESMA_QUESTION_CSDR_29>

Q30 Another potential approach to progressive penalty rates could be based not only on the length of the settlement fail but also on the value of the settlement fail. Settlement fails based on instructions with a lower value could be charged a higher penalty rate than those with a higher value, thus potentially creating an incentive for participants in settling smaller value instructions at their intended settlement date (ISD). Alternatively, settlement fails based on instructions with a higher value could be charged a higher penalty rate than those with a lower value. In your view, would such an approach be justified? Please provide arguments and examples in support of your answer, including data where available. What costs and benefits do you envisage related to the implementation of this approach? Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_30>

The consideration of any new criteria would represent a significant change compared to the current approach. The cost/ benefit ratio is too low to justify any change that will require relevant IT developments (including testing) for any EU/ EEA CSDs, T2S and participants and would make the application of penalty rates much more complex for transactions failing for more than one day (and including late matching fails).

Moreover, this proposal (like the introduction of a minimum or rates depending from the type transaction) breaches the immunisation principle since settlement is not made of "one to one" instructions

Progressive penalty rates –	Settlement fails based on lower value settlement instructions could be charged	Settlement fails based on higher value settlement instructions could be charged
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based on the length and value of the settlement fail	a higher penalty rate than those based on higher value settlement instructions		a higher penalty rate than those based on lower value settlement instructions	
	Qualitative description	Quantitative description/ Data	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<ESMA_QUESTION_CSDR_30>

Q31 Besides the criteria already listed, i.e. type of asset, liquidity of the financial instruments, duration and value of the settlement fail, what additional criteria should be considered when setting proportionate and effective cash penalty rates? Please provide examples and justify your answer.

<ESMA_QUESTION_CSDR_31>

No additional criteria should be considered as any new criteria would represent a significant change compared to the current approach. The cost/ benefit ratio is too low to justify any change that will require relevant IT developments (including testing) for any EU/ EEA CSDs, T2S and participants and would make the application of penalty rates much more complex for transactions failing for more than one day (and including late matching fails).

<ESMA_QUESTION_CSDR_31>

Q32 Would you be in favour of the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail? ESMA would like to ask for the stakeholders' views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_32>

Simplicity and clarity of the penalty mechanisms are crucial factors for their effectiveness. Complex mechanisms do not only pose challenges in terms of implementation and administration, but can also be difficult to convey to customers when penalties are passed on to them.

Therefore, **using straightforward and easily understandable penalty mechanisms ensures that market participants can grasp the rationale behind penalty assessments.** This transparency not only facilitates compliance but also enhances the overall effectiveness of the penalty system by promoting a clear understanding of the consequences associated with settlement-related actions or inactions.

Having said that, **the EBF advises against the use of the market value of the financial instruments on the first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail.** There is a lack of analysis of the feasibility and effects of such a system, and our view is that it would be overly complex and lead to many questions (e.g. would it also be used for late matching fails? How should financial instruments that are not traded daily be treated?). Our view remains that the same mechanism should apply to all instruments to avoid complexity, and that costly revisions of the current regime should only be implemented if a thorough analysis shows that the benefits outweigh the costs.

Use the market value of the financial instruments on the	
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first day of the settlement fail as a basis for the calculation of penalties for the entire duration of the fail		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<ESMA_QUESTION_CSDR_32>

Q33 How should free of payment (FoP) instructions be valued for the purpose of the application of cash penalties? Please justify your answer and provide examples and data where available.

<ESMA_QUESTION_CSDR_33>

They should be valued using the same methodology as used for against payment transactions, in order to maintain the “immunisation principle”.

<ESMA_QUESTION_CSDR_33>

Q34 Do you think there is a risk that higher penalty rates may lead to participants using less DvP and more FoP settlement instructions? Please justify your answer and provide examples and data where available.

<ESMA_QUESTION_CSDR_34>

No, the choice of using DvP or FoP is driven by other considerations rather than by the potential impact of fail penalties.

<ESMA_QUESTION_CSDR_34>

Q35 ESMA is considering the feasibility of identifying another asset class subject to lower penalty rates: “bonds for which there is not a liquid market in accordance with the methodology specified in Article 13(1), point (b) of Commission Delegated Regulation (EU) 2017/583 (RTS 2)”. The information on the assessment of bonds’ liquidity is published by ESMA on a quarterly basis and further updated on FITRS. However, ESMA is also aware that this may add to the operational burden for CSDs that would need to check the liquidity of bonds before applying cash penalties. As such, ESMA would like to ask for the stakeholders’ views on the costs and benefits of such a measure. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_35>

Applying lower penalty rates for illiquid bonds		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

More granular differentiation of instruments based on criteria such as their liquidity can be helpful to provide for better penalties calibration. However, this should be considered against the additional technical implementation costs for all FMIs and intermediaries. Golden source

database maintained by ESMA will be key to ensure full transparency and alignment about what penalties to be applied for each fail.

Overall, it is essential to prioritize simplicity and transparency in the penalty calculation process to ensure that market participants can easily grasp the rules and implications. This not only facilitates a clearer understanding of the penalty mechanism but also empowers parties to scrutinize and contest any penalties that may have been inaccurately calculated.

Against this background, one must emphasize that the inclusion of more asset classes could just as well introduce unnecessary complexity into the penalty framework without clear advantages.

Promoting a transparent and comprehensible penalty system not only aligns with the principles of fairness and accountability but also contributes to a smoother interaction between market participants and the regulatory framework. Clarity in penalty calculations supports a more efficient and responsive settlement environment by allowing for effective communication and resolution in cases where concerns or discrepancies arise.

<ESMA_QUESTION_CSDR_35>

Q36 Do you have other suggestions for further flexibility with regards to penalties for settlement fails imposed on illiquid financial instruments? Please justify your answer and provide examples and data where available.

<ESMA_QUESTION_CSDR_36>

The existing framework provides ample room for both parties to collaboratively adjust instructions, allowing for a more adaptive and responsive approach to settlement processes. It is within their discretion to cancel or modify instructions based on mutual agreement and, if needed, incorporate new parameters to facilitate smooth settlement. Encouraging a proactive utilization of this existing flexibility can contribute to a more dynamic and efficient settlement environment.

This flexibility can be particularly advantageous in situations where unexpected developments or changes in circumstances warrant adjustments to settlement instructions. By promoting increased utilization of this mechanism, market participants can enhance their ability to navigate evolving conditions, fostering a settlement process that is not only effective but also responsive to the dynamic nature of financial markets

<ESMA_QUESTION_CSDR_36>

Q37 How likely is it that underlying parties that end up with “net long” cash payments may not have incentives to manage their fails or bilaterally cancel failing instructions as they may “earn” cash from penalties? How could this risk be addressed? Please justify your answer and provide examples and data where available.

<ESMA_QUESTION_CSDR_37>

It is not clear that this is a major problem. A party that misuses CSD functionalities in order to receive an undue cash penalty may always receive a bilateral claim from its counterparty.

Nonetheless, there are steps that should be taken to minimise the risk of any such cases.

Such steps include:

- Encouraging partial settlement
- Advancing the point in time at which matched failing transactions are automatically cancelled (and, if necessary, replaced by a new instruction). Such a cancellation should take place at the latest twenty (or thirty) business days after intended settlement date. Such a change will facilitate increased discipline in the settlement process, as required by a potential EU move to T+1, and as also required by elements of the FASTER withholding tax proposal.

<ESMA_QUESTION_CSDR_37>

Q38 How could the parameters for the calculation of cash penalties take into account the effect that low or negative interest rates could have on the incentives of counterparties and on settlement fails? Please provide examples and data, as well as arguments to justify your answer.

<ESMA_QUESTION_CSDR_38>

<ESMA_QUESTION_CSDR_38>

Q39 To ensure a proportionate approach, do you think the penalty mechanism should be applied only at the level of those CSDs with higher settlement fail rates? Please provide examples and data, as well as arguments to justify your answer. If your answer is yes, please specify where the threshold should be set and if it should take into account the settlement efficiency at:

- a) CSD/SSS level (please specify the settlement efficiency target);**
- b) at asset type level (please specify the settlement efficiency target); or**
- c) other (please specify, including the settlement efficiency target).**

<ESMA_QUESTION_CSDR_39>

No. Such a step would be a major step backwards towards inefficient and fragmented European markets. It would go against the legislators' intention to have an harmonised framework (even as regards penalties) for European CSDs.

Although CSD functionalities and opening hours do have an impact on settlement efficiency rates, other important drivers of settlement efficiency include the type of securities, the type of activity, and the actions and internal processes of individual market participants.

Applying penalties only at CSDs with higher settlement fail rates would create fragmentation in European markets, would distort competition between CSDs, and would create particular problems for the application of penalties for settlement activity taking place in CSDs that use the T2S platform.

<ESMA_QUESTION_CSDR_39>

Q40 Please specify what costs and benefits you envisage regarding the application of the penalty mechanism only at the level of the CSDs with higher settlement fail rates. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_40>

Application of the penalty mechanism only at the level of	
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CSDs with lower settlement fail rates		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

In addition to our response to Question 39, especially for T2S CSDs, such approach would be extremely counterproductive: for T2S and its participants, the running and development cost of the penalty mechanism would be attributed to a much smaller customer base, hence, heavily increase the cost distributed to few CSDs and clients what will make the use of such CSDs or even T2S unreasonable. For T2S, significant impact/ cost can be expected

<ESMA_QUESTION_CSDR_40>

Q41 Do you think penalty rates should vary according to the transaction type? If yes, please specify the transaction types and include proposals regarding the related penalty rates. Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_41>

No. This will break the immunisation principle, as chains of failing settlement instructions may be made up of transactions of different types.

Applying uniform penalty rates, regardless of the trade type, ensures a straightforward and transparent approach to enforcing penalties. It eliminates the potential for manipulation by discouraging participants from choosing specific transaction types solely based on their penalty implications. This simplification of the penalty mechanism promotes fairness and

equity, fostering a level playing field for all market participants. In addition, the transaction type is not a matching criteria for settlement transactions, hence, the information could deviate between the securities delivery and receipt leg of a transaction making the application of penalties based on this criteria “random” at best.

Furthermore, a consistent penalty framework serves to maintain the integrity of the settlement system, as it discourages attempts to game the penalty structure. This approach aligns with the overarching goal of creating a robust and reliable settlement environment that operates on principles of fairness, accountability, and efficiency.

The cost/ benefit ratio is too low to justify any change that will require relevant IT developments (including testing) for any EU/ EEA CSDs, T2S and participants and would make the application of penalty rates much more complex

Applying penalty rates by transaction types		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

<ESMA_QUESTION_CSDR_41>

Q42 Do you think that penalty rates should depend on stock borrowing fees? If yes, do you believe that the data provided by data vendors is of sufficient good quality that it can be relied upon? Please provide the average borrowing fees for the 8 categories of asset class depicted in Option 1. (i.e. liquid shares, illiquid shares, SME shares, ETFs, sovereign bonds, SME bonds, other corporate bonds, other financial instruments).

<ESMA_QUESTION_CSDR_42>

On a principal level, we understand and agree with the idea that it should be more expensive to fail, than to take a securities lending position – if the information could be sourced, and then used without additional cost

Therefore, there is a rationale for penalty rates to be broadly linked to stock borrowing fees.

However, our view is that data vendors do not have sufficient data on lending fees. Hence, we advise against letting penalty rates depend on stock borrowing fees.

<ESMA_QUESTION_CSDR_42>

Q43 Do you have other suggestions to simplify the cash penalty mechanism, while ensuring it is deterrent and proportionate, and effectively discourages settlement fails, incentivises their rapid resolution and improves settlement efficiency? Please justify your answer and provide examples and data where available. Please specify what costs and benefits you envisage related to the implementation of your proposal. Please use the table below. Where relevant, additional tables, graphs and information may be included in order to support some of the arguments or calculations presented in the table below.

<ESMA_QUESTION_CSDR_43>

Respondent's proposal (if applicable)		
	Qualitative description	Quantitative description/ Data
Benefits	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Compliance costs: - One-off - On-going	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Costs to other stakeholders	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE
Indirect costs	TYPE YOUR TEXT HERE	TYPE YOUR TEXT HERE

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<ESMA_QUESTION_CSDR_43>

Q44 Based on your experience, are settlement fails lower in other markets (i.e USA, UK)? If so, which are in your opinion the main reasons for that? Please also specify the scope and methodology used for measuring settlement efficiency in the respective third-country jurisdictions.

<ESMA_QUESTION_CSDR_44>

There are very significant differences in market structure and market practice between the EU and the US.

Some significant differences: no settlement finality legislation in the US; settlements are processed as “stock dumps” and can be returned to the delivering party after SD, under the “DK” – “don’t know” procedure; no tracking of ISD by DTCC.

DKs occur for a rather significant portion of settlements (approx.. 5-10%, both at DTCC and at FED), so that the publicly-reported settlement efficiency statistics are grossly overstated versus a broader perspective that encompasses CSD participants and their clients.

As a result, it is very difficult to produce statistics on EU and US settlement efficiency that are comparable.

We are aware of some data that suggest for some comparable activities EU settlement rates are higher than US settlement rates.

<ESMA_QUESTION_CSDR_44>

Q45 Do CSD participants pass on the penalties to their clients? Please provide information about the current market practices as well as data, examples and reasons, if any, which may impede the passing on of penalties to clients.

<ESMA_QUESTION_CSDR_45>

It is a common practice for EBF members to pass on penalties to their clients.

However, it may well be the case that an EBF member, even if it generally passes on penalties, does not pass on penalties associated with a particular type of activity, or with a particular type of client, given the specificities of the type of activity, or the type of client (e.g., retail clients).

We believe that there should be full alignment of debit/credit penalties against the parties that are directly able to act towards the successful completion of settlement instructions – there should not be parties that, by design of the settlement discipline regime, are always net receivers of penalty credits, as this may lead to adverse and inappropriate behaviours.

<ESMA_QUESTION_CSDR_45>

Q46 Do you consider that introducing a minimum penalty across all types of fails would improve settlement efficiency? Is yes, what would be the amount of this minimum penalty and how should it apply? Please provide examples and data, as well as arguments to justify your answer.

<ESMA_QUESTION_CSDR_46>

Two ways of interpreting the idea of a minimum penalty:

1/ Penalties below the minimum do not apply.

2/ Penalties below the minimum are raised to the minimum level.

While Approach 1 may be linked to apparent advantages, one must emphasize that it contains substantial disadvantages as well. These relate in particular to increased complexity and breach of the immunisation principle.

On the other hand, approach 2 has major disadvantages. It will create anomalies, complexity and cost, and could be very disproportionate for settlement transactions of low value.

Also, such change would require significant IT developments (including testing) for any EU/EEA CSDs, T2S and participants and would make the application of penalty rates much more

<ESMA_QUESTION_CSDR_46>

Q47 What would be the time needed for CSDs and market participants to implement changes to the penalty mechanism (depending on the extent of the changes)? Please provide arguments to justify your answer.

<ESMA_QUESTION_CSDR_47>

The process of penalty calculation is within the purview of the Central Securities Depositories (CSDs) or Target2-Securities (T2S). Consequently, the primary responsibility for addressing this question lies with these entities.

It is imperative to afford market participants an adequate lead time for timely communication to clients. This allows for effective planning and communication strategies, ensuring that market participants can convey relevant information to their clients in a timely manner. Providing an sufficient lead time facilitates a smoother and more transparent communication process between market participants and their clients in response to penalty-related matters.

E.g. from the date of issuance of the final ESMA RTS, depending on the significance of the changes required, for internal developments of our members and including testing with participants/clients and T2S, at least 12 to 18 months will be required.

More development time may be needed by the 4CBs for changes in T2S.

<ESMA_QUESTION_CSDR_47>

Q48 Since the application of the RTS on Settlement Discipline, how many participants have been detected as failing consistently and systematically within the meaning of Article 7(9) of CSDR? How many of them, if any, have been suspended pursuant to same Article?

<ESMA_QUESTION_CSDR_48>

<ESMA_QUESTION_CSDR_48>

Q49 In your view, would special penalties (either additional penalties or more severe penalty rates) applied to participants with high settlement fail rates be justified? Should such participants be identified using the same thresholds as in Article 39 of the RTS on Settlement Discipline, but within a shorter timeframe (e.g. 2 months instead of 12 months)? If not, what criteria/methodology should be used for defining participants with high settlement fail rates? Please provide examples and data, as well as arguments to justify your answer.

<ESMA_QUESTION_CSDR_49>

We do not believe that applying special penalties for participants with high settlement fail rates would be justified. In fact, we believe that applying such penalties would create the risk of damage to key elements of the European post-trade system.

This view is based on the following considerations.

1/ Such special penalties are not necessary as, firstly, the rates for late settlement penalties should be calibrated so that all market participants have incentives for timely settlement, and as, secondly, supervisory bodies already have existing powers with relation to bad behaviour by market participants.

2/ Such special penalties will create anomalies, and will damage, or create inappropriate incentives, for parties that are not at fault. This is because a CSD participant may be acting as an intermediary, and the settlement fail rates on a specific CSD account may reflect the activities of multiple underlying trading parties, some of which may have good behaviour, and some of which may have bad behaviour. Given that CSDs will not be able to distinguish between transactions of a party with good behaviour, and transactions of a party with bad behaviour, the application of special penalties creates the risk that parties with good behaviour will be unduly penalised, and with no ability of recourse.

It is also unclear who would benefit from such fees and how they should be processed/ paid when ESMA states “These special penalties would be in addition to the general cash penalty mechanism provided for in CSDR. In principle, they would not be credited to the participant’s counterparties and should not represent an additional source of income for the CSD.”.

Leaving aside any IT development cost (including for T2S) we believe the existing “suspension” process (see as well Question 48) perfectly serves the purpose to incentivise relevant participants to take mitigating actions, whenever possible

<ESMA_QUESTION_CSDR_49>

Q50 How have CSDs implemented working arrangements with participants in accordance with article 13(2) of the RTS on Settlement Discipline? How many participants have been targeted?

<ESMA_QUESTION_CSDR_50>

<ESMA_QUESTION_CSDR_50>

Q51 Should the topic of settlement efficiency be discussed at the CSDs' User Committees to better identify any market circumstances and particular context of participant(s) explaining an increase or decrease of the fail rates? Please justify your answer.

<ESMA_QUESTION_CSDR_51>

Yes. The topic of settlement efficiency is an appropriate topic of discussion at CSD User Committees.

One reason for this is that the settlement efficiency rate of any individual market participant is affected by the settlement efficiency rate of other market participants, so that it is appropriate for there to be broad market discussions on how to improve settlement efficiency.

Another reason is that overall settlement rates are affected both by CSD functionalities and by CSD daily timetables. It is important that CSD User Committees discuss how to change CSD functionalities and CSD daily timetables in order to improve settlement rates.

It is important that CSDs should be required to provide detailed information to their participants about settlement efficiency in their respective SSS. In order to ensure full comparability across FMIs and across markets, this information should be compiled using the same settlement efficiency definitions, data granularity and KPIs across all markets, as noted above in Q15 and Q21.

<ESMA_QUESTION_CSDR_51>