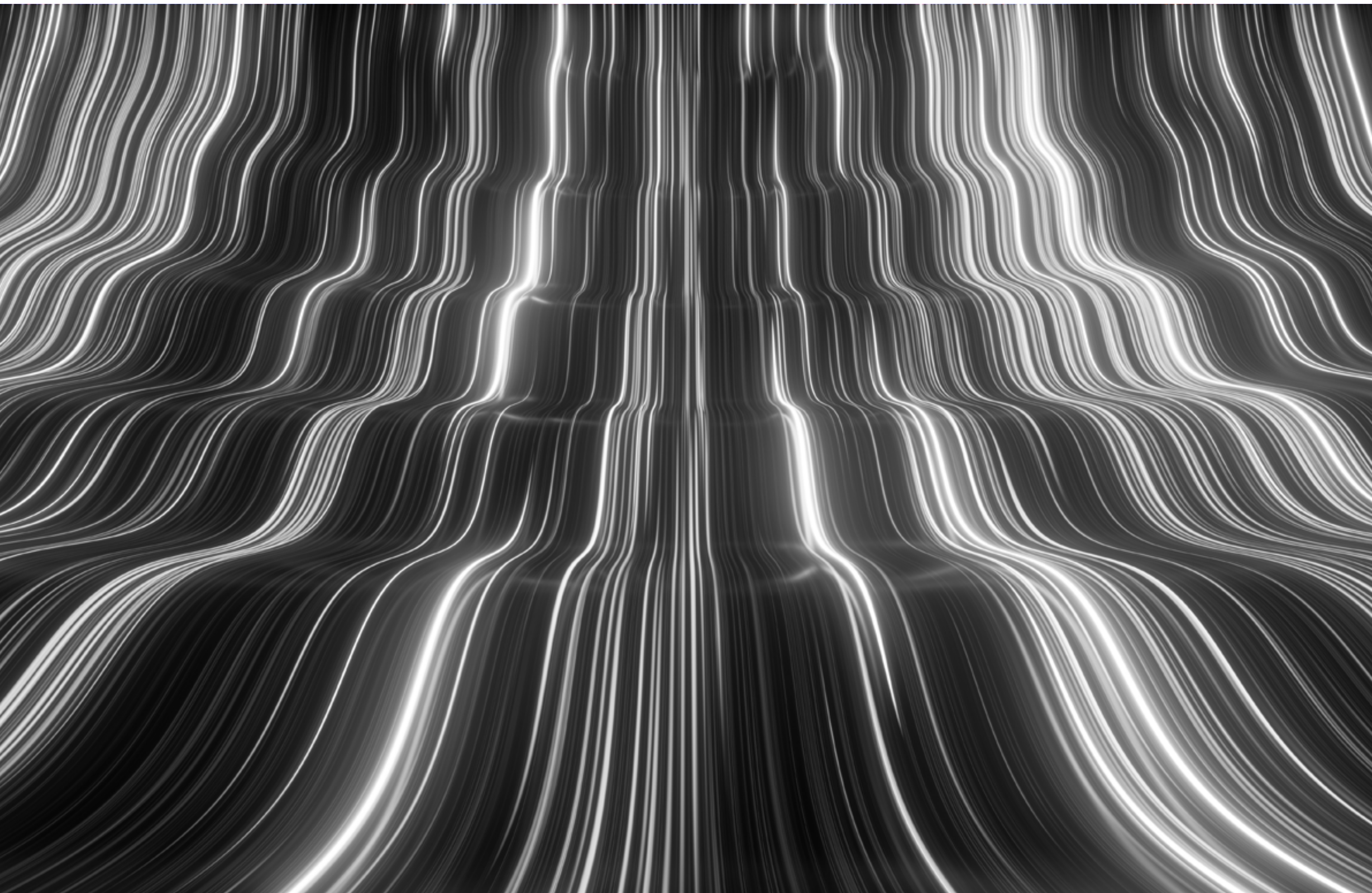
CAPCO

# SETTLEMENT DISCIPLINE REGIME (SDR):

## THE REGULATION SET TO DISRUPT SECURITIES MARKETS



In July 2014, the European Parliament and Council issued Regulation (EU) No 909/2014 (CSDR) with the aim to harmonize and improve efficiency of securities settlement across EU markets. Article 6 & 7 of the regulation, commonly referred to as Settlement Discipline Regime (SDR[1]), introduce standardization across allocations and confirmations processing, call for automation of the settlement process and implement penalties and mandatory buy-ins upon the instance of settlement failure.

### Measures to Prevent Settlement Fails

- Written allocation and confirmation required on the same day or by 12pm the next day
- Receipt of allocation/ confirmations to be confirmed within 2 hours
- Usage of electronic allocations platforms
- Automation of settlement process at CSD and CSD settlement functionalities including partial settlement, hold/release and bilateral cancellation

### Cash Penalties for Late Settlement

- Cash penalties for matched instructions failing to settle on ISD applied until transaction settled or cancelled
- Different penalty rate depending on type and liquidity of the instrument
- All transaction types in scope with exception of corporate actions, redemptions and T2S technical instructions
- Penalties redistributed by CSDs to non-defaulting CSD participants

### Mandatory Buy-In Regime

- Requirement for trading parties to initiate mandatory buy-in after expiry of extension period (ISD +4 for equities, ISD+7 for bonds, ISD +15 for SME growth market)
- All transaction types in-scope excluding short term repos
- Buy-in agents appointed to effect the buy-ins
- Price deferential paid by the failing party and cash compensation where buy-in not possible
- Reporting requirements

These measures have increased the need to develop seamless operational and technological methods to identify, manage and ultimately prevent settlement fails, in turn mitigating both the risk of non-compliance with CSDR and related fines.

The practical implementation of CSDR presents a number of challenges and we expect further regulatory guidance to come out before the February 2021 go-live date.

In this article we outline our recommended implementation approach and some key considerations for designing solutions and operational processes in preparation for next February.

1. In this article, the terms SDR and CSDR are used interchangeably and refer to article 6 and 7 of CSDR regulation.

# DAY 1 VS. STRATEGIC DELIVERY

The implementation focus is a balancing act between being ready for 'day 1' and addressing strategic changes in the settlement space.

The impact of the regulation will be directly correlated with the firms' ability to reduce number of settlement fails. However, given the limited time, dependency on other market participants and availability of resources, firms need to balance what they can deliver for go-live (day 1 solution) and strategic initiatives aimed at improving settlement efficiency.

| Day 1 Solution | Strategic Considerations |
|---|---|
| • **Cash penalty regime readiness:** receive, reconcile, allocate and pay penalties<br>• **Buy-ins regime readiness:** identify approaching buy-ins, appoint buy-in agent, manage settlement instructions and notification across buy-in lifecycle, calculate price differential and cash compensation<br>• **Allocations & confirmations:** electronic methods for allocations, monitoring allocation and workflow to adhere to timing requirements<br>• **Contractual changes & repapering:** changes to support SDR regime | • **Pre-matching and vendor landscape:** apply market solutions to increase pre-matching and reduce matching fails<br>• **SSI management Infrastructure:** optimize sources of SSIs, internal processes and systems<br>• **Inventory management:** align front office and back office view of positions settlement status<br>• **Revenue opportunities:** new services to help clients improve settlement efficiency and manage their CSDR obligations<br>• **Fails management workflow:** front to back alignment and external communication |

Firms need to understand their current number of settlements fails, top drivers, and the resulting CSDR cash penalty and buy-in cost. Based on that view, they will be able to define optimal day 1 solutions that will ensure regulatory compliance with a sufficient level of automation and controls required for the go-live, and effectively sequence strategic initiatives to minimize CSDR exposure in the long run. We therefore recommend the following implementation approach:

| Impact Assessment | | Solution Design | |
|---|---|---|---|
| **1.** Understand current fails and resulting CSDR cash penalty and buy-in cost | **2.** Identify and prioritise root-cause for fails driving CSDR exposure | **3.** Define optimal day 1 solution to mitigate immediate CSDR impact | **4.** Define strategic roadmap for reduction of settlement fails |

In the subsequent sections of the paper we explore key considerations across impact assessment and solution design that are important in navigating the CSDR requirements landscape and reaching that right implementation balance.

# KEY CONSIDERATIONS

## Impact Assessment

The impact assessment phase includes scoping, commercial impact assessment, and primary root-cause analysis to allow firms understand the size of the 'problem'.

The commercial assessment, including estimation of cash penalties and buy-ins based on the current level of fails, will provide the firms with a view of the impact on P&L if no steps are taken to improve settlement efficiency. It is a powerful message – a tool for engaging the front office (FO) stakeholders and a step towards bridging the gaps between trading floor operating on the perfect settlement assumption and the operations function managing the settlement instructions, depot realignments and settlement fails. To manage the impact of CSDR, greater cooperation and common view across these two functions will be required.

Analysis of the settlement data will allow to start unpicking root-causes of fails, needed technology and process improvements. The response to some of them might be short, quick fixes and for other long-term initiatives that cannot be delivered before CSDR go-live.

Having completed the impact assessment and fails analysis, the firms should have the foundation to start identifying day 1 priorities and the strategic roadmap.

| | Theme | Key Considerations | Capco Perspective | Benefits |
|---|---|---|---|---|
| **1. Current Level of Fails & CSDR Cost** | Scope | • While most attention will be on European entities, trades executed by non-European entities will be in scope if settled on EEA CSDs (excluding instruments where primary trading venue is outside of EEA) | • Intercompany trades including onward deliveries can be a source of penalties and need to be investigated as part of CSDR impact assessment<br>• Back to back/washbook models need to be reviewed | • Accurate CSDR cash penalties and buy-in cost estimates<br>• Ability to determine optimal solutions given expected level of fails and CSDR cost<br>• Ability to design settlement efficiency roadmap and ensure alignment with strategic changes<br>• Ability to determine headcount augmentation requirements<br>• Non-compliance risk mitigated |
| | Late Matching | • In case of matching fails the penalty will be levied to the counterparty who was the last to amend instructions – this information is not available in firms' settlement systems<br>• On the contrary, there will be scenarios where CSDs do not have visibility of who truly caused the late matching and may assign the penalty incorrectly | • Deep dive analysis of current fails can allow to establish approx. % split of matching fails culpability<br>• That % split can be used to estimate cash penalties on matching fails<br>• Cases where instructions where amended late on the request of counterparty/client should be tracked | |
| | Commercial Impact | • Depending on its role in a settlement chain, a firm may need to pay or pass CSDR penalties cost<br>• CSDR may affect liquidity and prices of securities resulting in high price premiums on bought in trades; as per the regulation, failing party needs to settle price deferential but cannot benefit from the price movement | • In case of prime brokerage the dual role as a trading party and a settlement agent needs to be considered<br>• Estimation of buy-in price premiums should in be considered as part of CSDR impact assessment | |
| | Reference Data | • Calculation of CSDR cost requires reference data to establish if a transaction is in-scope, determine penalty rate based on instrument type and place of trading, and decide length of the extension period for buy-ins | • Internal solutions need to consume this data not only for cost estimation but also fails prioritization<br>• Off the shelf solutions exist in the market that will allow to estimate CSDR cost without sourcing reference data | |
| **2. Top Fail Reasons** | Primary Root-cause | • Fails are caused by mismatch in economics, wrong SSIs, short stock or short cash<br>• However, identification of primary root-causes requires deep-dive investigation and joining of front-to-back data across trade life-cycle | • Fails remediation is a continuous process of discovery, primary root-cause investigation, solution design and benefit tracking. Accessible user-friendly interfaces for exposure of the data can accelerate investigation and help expose trends | |
| | Aged Fails | • Most firms will likely have settlement fails that have been outstanding for a while<br>• Those may attract penalties post CSDR go-live | • Any clean up exercise must start now and can reveal further flaws in the front to back process<br>• Where trades are outstanding due to corporate action on stock those need be excluded from cost estimates | |

→ **Solution Design**

## Solution Design - Day 1

All firms operate to a set of constraints and dependencies – time to go-live, in-flight projects, availability of resources and so on. Knowing the size of the 'problem' and having understanding of long-term goals will allow the firm to determine the level of technology investment and operational controls required to manage the mandatory obligations under CSDR: allocations & confirmations, cash penalties and buy-ins.

The table below captures key considerations that will help navigate the regulatory requirements and to design a day 1 solution that adequately address these:

3. Optimal Day 1 Solution

| Theme | Key Considerations | Capco Perspective | Benefits |
|---|---|---|---|
| Cash Penalty Regime | • The key part of designing cash penalty solution is defining reconciliation requirements and cost allocation model<br>• Both are likely to be driven by the size of expected CSDR penalties determined as part of impact assessment | • Leverage current processes and solutions for agent fee allocation or TMPG interest claims<br>• Ensure the solution accounts for the cash penalty aggregation and reporting methods applied by FMIs. | • Optimal solution for cash penalties given expected monetary impact<br>• Optimal solution for buy-ins given expected volumes<br>• Reduced risk of solution design gaps and go-live risk<br>• Front to back alignment reducing risk of duplicate deliveries/ short positions<br>• Improved settlement efficiency<br>• Go-live readiness |
| | • There are differences in implementation details across CSDs, CCPs and other market participants; lack of market alignment and information from each FMI present a go-live risk | • Engage with ECSDA/EACH to drive consistency<br>• Conduct FMI outreach and focus on FMIs with highest volume of firm's trades | |
| Buy-in Regime | • Buy-in solution design requires definition oft the operating model including roles and responsibilities, processes and technology required<br>• Considerations need to be given to the front office processes including inventory management and exposure pre and during buy-in lifecycle<br>• Expected volume of buy-ins will underpin the requirements | • Firms should engage stakeholders across trading, settlement and finance to design a robust process<br>• The process and technology solution need to facilitate front to back alignment that will allow the firm to effectively prevent and manage buy-ins | |
| | • Regulatory ambiguity remains in relation to buy-in exemptions, pass on mechanism, alignment with ICMA rules including price asymmetry in price difference settlement<br>• These will likely impact solution design | • Active participation in industry forums is pivotal in ensuring solution alignment with industry best practice and the latest regulatory guidelines; they are also an opportunity to actively shape the future state | |
| | • Buy-in agent utility platforms offer one stop shop for executing buy-ins however possibility and cost of using existing broker network should be considered | • Vendor questionnaires can facilitate assessment of available options and speed up selection process | |
| Allocations & Confirmations | • Firms will need to ensure that all data points are captured to track timeliness of confirmations and allocations<br>• Promoting usage of electronic platform will be key, however, some market participants might be reluctant to adopt those and continue to provide information in non-electronic formats<br>• CSDR does not provide explicit punitive measures for non-compliance | • Promote standardization of non-electronic inputs<br>• Some of the CSDR penalties could be reclaimed from end clients not-complying with Allocations & Confirmations requirements<br>• Some of Allocations & Confirmations' regulatory requirements need to be addressed through contractual agreements | |
| Contractual Changes | • Implementation of CSDR requires changes to contractual agreements and terms of business<br>• There will be challenges on in-scope jurisdictions and agreement types | • Planning for repapering needs to start now<br>• There are industry forums driving discussion around interpretation of contractual requirements | |

Solution Design

## Solution Design - Strategic Roadmap

In the strategic roadmap, firms should focus on long-term changes beyond direct regulatory obligations. At the heart of CSDR regulation is improved settlement efficiency across European markets. The stipulated punitive measures are a way of bringing securities settlement efficiency at the forefront of the agenda and incentivizing market participants to act on it. As part of the strategic roadmap, firm should reconsider the front to back securities flow – trading strategy, technology they use to support it, the operational process around it, as well commercial opportunities that would address some of the market needs and contribute to the improvement of the overall efficiency across European markets.

We have outlined below some key areas that should be considered:

4. Strategic Roadmap

| Theme | Key Considerations | Capco Perspective | Benefits |
|---|---|---|---|
| Pre-matching & Vendors | • Increasing pre-matching coupled with usage of electronic platforms will be key in reducing the number of matching fails and late settlement<br>• SSIs are considered a static data however SSI modification is a common and frequent occurrence | • There are platforms in the market that facilitate pre-matching at trade allocation and settlement level<br>• For clients reluctant to switch to vendor solutions, free offering exists to allow them modify SSIs | • Improved settlement efficiency<br>• Better front-to-back alignment and increased operational efficiency<br>• New services and sources of revenue |
| SSI Management | • Despite some firms will be utilizing electronic/ vendor SSI inventories and allow clients to view and modify SSI data, they lack STP/ automated link to feed this data to settlement layers | • Firms need to limit the number of SSI information entry routes, internal depositories and touchpoints<br>• There is a need for standardization of SSI formats across markets | |
| Inventory Management | • The view of inventory status is often different at front office and settlement layer, with both parts of the organization performing activities affecting stock availability across depots | • Achieving one, real time view across the organization is the first step to efficiently utilize auto-borrow and SBL services | |
| Revenue Opportunities | • CSDR will likely create an increased in demand for securities borrowing and lending<br>• Clients are likely to demand greater transparency and efficiency from their brokers, custodians and other providers when faced with costs of CSDR | • Very few market participants have come forward to offer buy-in agent services<br>• Transparency, real time data and easily accessible dashboards will see increase in demand | |
| Fails Management Workflow | • CSDR highlights the need for internal front to back alignment and STP across trade lifecycle as well better collaboration across internal functions<br>• Equally, it calls for better collaboration across market participants to prevent and tackle fails, and improve overall settlement efficiency | • While most firms will have fails management tools, those tend to be used only by operations; extending functions and users of those tools may boost collaboration and lead to faster issue resolution<br>• There are vendors in the market that facilitate access to real-time information sharing across market participant | |

Solution Design

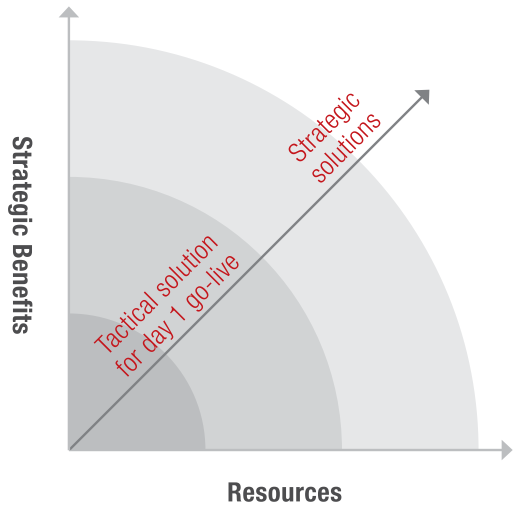
# HOW WE CAN HELP

CSDR is set to disrupt the securities markets across Europe and while the objective of the regulation is to improve settlement efficiency, in the short term the regulation may result in substantial cost to market participants and will require front to back changes to manage the that exposure and comply with mandatory requirements of the regulation.

Capco has a strong presence across industry in helping clients deliver CSDR initiatives; from driving the reduction of fails through analysing settlement fails data and estimated CSDR exposure, to helping clients develop cash penalty and buy-in solutions and strategic product roadmaps.

We have a strong track-record in developing optimal solutions and target state operating models, and balancing the day 1 versus strategic deliveries based on our experience of working with multiple clients and leveraging our insights into key industry bodies such as ICMA and AFME.

Capco can help you define and design a bespoke and balanced CSDR solution, taking into account your tactical and strategic objectives, to ensure your institution is well positioned for go-live and beyond.



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## ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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