France Post-Marché

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ESMA
CONSULTATION PAPER
Technical Advice on CSDR Penalty Mechanism

FRANCE POST MARCHE PRESENTATION

FRANCE POST-MARCHE (previously named AFTI) was created in 1990, with the goal of gathering members of organizations in the Banking and Financial Services industry involved in activities with financial instruments and specifically post trade activities.

FRANCE POST-MARCHE is an integral part of the French, European and international financial ecosystem, supporting the increasingly interdependent players in the French financial marketplace.

FRANCE POST-MARCHE (FPM) is the leading association representing the post-trade business in France and Europe.

FPM represents through its 82 members a wide range of activities: market infrastructures, custodians, account-keepers and depositaries, issuer services, reporting, and data management services, with a total staff of 28,000 in Europe of which 16,000 in France.

Our members acting as financial intermediaries account for 26% of the European market.

CONTEXT

ESMA has launched on December 15th, 2023 a consultation paper on the review of the penalty mechanism under CSDR. This consultation paper aims at discussing with the industry various options to review some of its technical aspects in line with the text adopted for CSDR Refit.

In this context France Post Marche has collaborated with the French associations (AFG[1] and AMAFI[2] notably) and has gathered the opinion of its participants to elaborate a comprehensive answer to the questions asked by ESMA. France Post Marché however submit this answer on its own, and both AFG and AMAFI are providing their own answer to ESMA.

Before presenting our findings, we would like to thank ESMA for this consultation and for the opportunity to share France Post Marché views on the review of the penalty mechanism.

[1] Association Française de la Gestion financière (AFG) federates the asset management industry for 60 years, serving investors and the economy.
[2] Association Française des Marchés Financiers (AMAFI) is a trade association representing French financial markets participants of the sell-side industry which operates in all market segments, such as equities, bonds and derivatives, on primary and secondary markets

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MAIN VIEWS & CONCLUSIONS

As an introduction, we would like to recall that settlement efficiency is an important topic for financial institutions:

- **Even before the entry into force of the settlement discipline, settlement fails did – and still do – have a cost**, as they involve manual tasks, operational risks, financial risks notably when securities not delivered must be funded, and may trigger additional fails.
- **In France, settlement efficiency has been monitored even before 2010**, with market practices defined over time to improve it. Dedicated workgroups have designed market practices before the entry in force of settlement discipline, and have reinforced them or defined new ones in anticipation of the implementation of the penalty mechanism.

For this reason, **maximizing the chance that settlement occurs is a key objective of post-trade professionals**. The anticipation of settlement issues and the management of fails is the core task of securities back-offices, for brokers, investment banks, custodians – and their clients, notably investment management companies and institutional investors.

If penalties under CSDR can further incentivize timely settlement, there was prior to February 2022, and there still is already an incentive to do so, and financial institutions act accordingly.

With this in mind, the key elements we would like to outline as introductory note to our response are the following:

1. **Settlement efficiency is the result of many factors, and not only of behaviors**: (1) proper booking of the transaction, (2) efficient processing of confirmations and allocations, (3) efficient management of SSI, (4) efficient management of inventories and of transfers or recalls, (5) liquidity of the instrument, (6) proper use of functionalities aimed at fluidifying settlement such as hold & release, partial release or partial settlement and (7) use of borrowing programs/market to find securities on the market.

   Penalties, for these reasons, are not the only factor the regulator should consider to maximize settlement efficiency. Ensuring trading parties and their agents make the most of functionalities/services that will help automate the process and fluidify settlement should be a key objective, and not only evolutions in the penalty mechanism.

2. **We have observed some improvements since the introduction of penalties in February 2022**. On one hand, settlement fails have slightly reduced. On the other hand, the fluidification of settlement has been improved by a more generalized use of partial settlement and other functionalities.

3. **Options proposed represent a fundamental review of the penalty mechanism**, with the introduction of new structural features such as progressivity, convexity, or strong changes in the categorization of asset classes for option 2. **We believe such a drastic change is undesirable for 5 main reasons**:

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- **The introduction of penalties under CSDR is recent, and there is limited hindsight so far on the actual impact of penalties on settlement efficiency**. Other factors have been into play, such as new market practices to fluidify settlement, moving interest rates, or more liquidity on some instruments due to the unwinding of NCB-led purchase programs. With the actual effect remaining to be confirmed, changing key features only 2 years after the introduction of the mechanism bears the risk of not being understandable by the market.

- Besides the level of penalties, which appear in some cases too low and may not sufficiently incentivize the resolution of the fail, **no fundamental flaw has been detected on the key features of the penalty mechanism**: categorization of assets, calculation, processing, etc. Moreover, with settlement fails sharply declining after ISD+1 and ISD+2, **we believe there is no real business case for the inclusion of duration as a key feature of the mechanism**.

- **Most proposals made in the consultation paper will result in situations of imbalances, and put at a risk the principle, recalled by the regulator in previous texts, of neutrality / immunization of parties who are not the ultimately failing party**, such as intermediaries. We find cases where using partial settlement or borrowing securities will result in an imbalance for them between penalties paid and received. This is true of progressivity, and of convexity, and will also be the case should transaction types, value of the fail be included in the mechanism, or should a minimal penalty be introduced.

- Considering we have recently finished the implementation of the first settlement discipline project, at a time when the regulatory roadmap is already heavily loaded and when budget constraints are high, **engaging into a fundamental review of the penalty mechanism** (in particular should either option 1 or option 2 be retained), **of a size and length equivalent to the previous implementation, risks missing a key objective**, which is to bring a rapidly effective answer to the fact that penalties may be too low to act as a real incentive to solve the fail, as they should. At the time the new regime may be implemented it is likely the situation has already changed so that it may come too late. Moreover, should T+1 settlement cycle be considered, an additional review may be necessary, which could result in a double effort.

- Finally, **the proposed modifications introduce a level of complexity not present in the existing mechanism, that will be difficult to explain to clients and counterparties** and admitted by them. Thus, it will result in an increase in the number of disputes and claims, adding to the operational workload at all levels of the post-trade chain and miss the aim of educating market actors.

4. **We firmly believe that any evolution of the penalty mechanism should, on the contrary, be based on the following principles**:

   - It should be **easy** and **quick to implement**, and not require a large implementation project at market level;

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- It should be **simple to explain**, to ensure that clients of CSD participants (and upper the chain) and counterparties understand its purpose, calculation and functioning, including parties outside of the EU.

- It should remain **neutral for intermediaries and parties who are not the ultimately failing party, and immunize them** from any adverse effect that may result from an imbalance between penalties paid and received – where the fail is for not fault of their own;

- It should have as a target the objective that **the cost of fail outweighs the cost of solving the fail**, and limit the possibilities of arbitrage.

5. **Finally, for all these reasons, we strongly advocate for a simple evolution**, the key features of which would be the following:

   - **A significant but reasonable increase of the existing penalty rates**, mainly on liquid instruments, without the introduction of progressivity or convexity or other criteria;

   - A level of penalty rates that **takes into account the cost of borrowing securities, without technical dependance** between the two;

   - A **categorization of asset types identical to the existing one, with the exception** of a new separate category for ETF.

As a conclusion, we believe that, above all, the penalty regime shall remain a tool that makes the industry want to be an actor of the settlement efficiency's improvement.

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