Global Securities Services

NewsFlash

OTP Bank Group

Market: EU/EEA

Date: 28 December 2021

Short summary of CSDR regulation and Settlement discipline regime (SDR), new reporting, new clients' and OTP banka's obligations

CSDR Regulation

CSDR is an EU regulation No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories that came into force on 17 September 2014. It sets up a European-wide regulatory framework for the institutions responsible for securities settlement, Central Securities Depositories ("CSDs"). It removes some existing barriers to cross-border settlement, harmonizes the timing and conduct of securities settlement in Europe, and introduces rules relating to the safety and soundness of CSDs. While some of these requirements have become applicable already, the settlement discipline measures (SDR) which are the focus of this note are yet to become applicable from 01 February 2022.

Part of CSDR regulation is also Commission Delegated Regulation (EU) 2018/1229 of 25 May 2018 supplementing Regulation (EU) No 909/2014 of the European Parliament and of the Council with regard to regulatory technical standards on settlement discipline.

ECSDA CSDR Penalties Framework is a framework prepared by the ECSDA (European Central Securities Depositories Association) with the aim to integrate with the Commission Delegated Regulation (EU) 2018/1229 and harmonize the cash penalties mechanisms between CSDs within the scope of the CSDR or with any other similar regulations. CSDR therefore represents the market practice related to cash penalties.

The key impact of CSDR in respect of relevant transactions, which you undertake with counterparties and in relation to which we provide custody services, is the introduction of settlement discipline measures that aim to reduce settlement fails and, where they do occur, to ensure that they are resolved promptly and efficiently. One of such measures is the introduction of mandatory buy-in rules for certain transactions. Transactions in scope are purchase and sale of securities, collateral management operations, securities lending and borrowing, and repo transactions in which the second leg is intended to settle more than 30 business days after the first leg are captured, executed on a trading venue and over the counter (OTC) in the following securities:

- transferable securities (e.g. shares and bonds),
- money-market instruments,
- units in collective investment undertakings and
- emission allowances admitted to trading or traded on a trading venue located in the European Economic Area ("EEA") (and the United Kingdom ("UK") post-Brexit) or cleared by a central counterparty located in the EEA (and the UK, post-Brexit) which are settled on a CSD located in the EEA ("EEA CSDs") (and the UK, post-Brexit ("UK CSDs")). Derivatives do not fall into the CSDR scope.

The shares which are admitted to trading or traded on an EEA (or UK, post-Brexit) venue but where the principal venue for the trading of those shares is located in a third country are not subject to the mandatory buy-in requirements.

Financial instruments to be within the scope of SDR:
• ISIN of the financial instrument on ESMA Financial Instruments Database (ESMA FIRDS database)
• ISIN of the financial instrument not on the list of the excluded shares in accordance to the Regulation (EU) No. 236/2012 of the European Parliament and Council on short selling (SSR – Short Selling Regulation).

FIRDS database can hold financial instruments that are no longer included in the settlement system, and cash penalties for unsettled trades in those instruments will not be applied for days following the exclusion date. FIRDS database also contains financial instruments traded on the venues outside the EU member countries. These financial instruments are in the cash penalties scope when the actual matching and settlement are executed in the CSDs of the EU/EEZ member countries.

<u>Measures to prevent and address failures in the settlement of securities transactions</u>

Measures to prevent failures in the settlement of securities transactions:

- **Timely delivery and processing of financial instruments purchase/sale instructions**: OTP banka d.d. proposes delivery of settlement orders in csv file for automatic import into Securities Services Department system (STP process). The aim is to achieve greater operational efficiency and reduce the risk of applying late matching and settlement fail penalties. An example of a csv file can be provided at the client's request in January 2022.
  Upon entering the order into the system, the Securities Services Department will automatically send a report to the previously agreed clients' e-mail addresses: *Received Instructions of Financial Instrument Settlement Report on DD.MM.YYYY. / ______(portfolio name)_____*. OTP banka d.d. facilitated automatic IPRC/PACK MT548 messages immediately upon the receipt of the instruction.

- **Bilateral cancellation mechanism**; CSDs are obliged to operate a bilateral cancellation facility that requires participants to bilaterally cancel matched settlement instructions. Most EU/EEA CSDs currently operate with bilateral cancellation and those remaining unilateral cancellation markets will be updated to follow the new process.

- **Hold and release mechanism**; hold and release mechanism will not be supported by the Croatian central depository (SKDD). The mechanism will be introduced by all depositories within the EEA member countries if they meet certain provisions of the CSDR Regulation*. Clients can mark the pending transaction blocked, that is, put the transaction on hold without settlement, as well as release the instruction for further processing and settlement. If the instruction is already undergoing a buy-in process, the party responsible for settlement fail is obliged to block/hold the transaction. The hold and release mechanism can be instructed via MT530 message, MT54X message with PREA indicator, or via standard settlement instructions with the note to block the transaction, stating the order reference. OTP banka d.d. will confirm the status of the transaction, either via MT548 message or by an automatic e-mail statement *Transaction Status Report on DD.MM.YYYY. / _____ (portfolio name) _________*.

**based on the exclusion provisioned by the Article 12 of the RTS on settlement discipline – Croatian CSD does not meet the prescribed conditions*

- **Settlement instructions recycling:** central depositories recycle the instructions that lead to settlement fails until a point they finally settle or bilaterally cancel. For example, SKDD will cancel unmatched settlement instruction if it remains unmatched for 20 working days after the predicted settlement date, or 20 working days after the instruction entered the CSD system if released after the predicted settlement date. By cancelling the settlement instruction after 20 working days, the instruction receives the status "expired".

- **Partial settlement:** central depositories allow partial settlement of the instructions. By the end of the last working day of the extension settlement period, and on the markets where available, clients must allow partial settlement to avoid settlement fails and buy-ins. Before initiating a buy-in process, transaction **has to settle partially**; any party in the settlement that opted for no partial settlement must in this case accept multiple deliveries of the financial instruments, and amend the instruction accordingly. This will imply additional cancellation of the initial instruction and releasing new instructions. Previously submitted standing instructions on partial settlement will have to be individually regulated/amended. Croatian depository (SKDD) will not enable partial settlement services*.

- **Tolerance level**: CSDs set cash tolerance level, which represents the highest difference between the settlement amounts in two corresponding instructions that can still match. The instructions are matched if the difference between the presented cash amounts is no more than EUR 2, 00 for the settlement of transactions in an amount up to 100.000,00 EUR, or EUR 25, 00 for the settlement of transactions in an amount over EUR 100.000,00. For settlement instructions in other currencies, the settlement tolerance level is equal to the EUR amount at the official EUR exchange rate published by the European Central Bank, if available. In case your instruction settles with the settlement tolerance level, this will be clearly stated on the Confirmation of Settled Transactions.

- **Additional information on settlement instructions**: simultaneously with CSDs, OTP Banka d.d. will introduce additional settlement report; Transaction Status Report or MT548 message, depending on the agreed communication channel with the client. The report will contain all pending transactions which can settle on predicted settlement date, failed instructions that will not settle on predicted settlement date, fully settled instructions, partially settled instructions (divided into settled and unsettled quantities and/or cash), and expired/cancelled instructions. For cancelled instructions, report will contain the additional information on which party cancelled the transaction (the system or the market participant).

  Transaction Status Report on DD.MM.YYYY. / _____ (portfolio name) _________/MT548** messages will be released by the system in several intervals on daily basis. Clients will be informed on the intervals and reporting channels in due time.

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***MT548 messages will be delivered by swift to all the clients with the agreed communication channel. To all the clients who do not have swift as agreed means of communication, the above-mentioned reports will be delivered by e-mail.*

Addressing Settlement Fails

- CSDs will additionally monitor and report on settlement fails. The information on settlement fails will be annually published on CSDs' websites, free of charge.
- CSDs will daily calculate and charge cash penalties for all instructions that are not matched on time (LMFP = Late Matching Fail Penalty), and for all instructions that are not settled on predicted settlement date (SEFP = Settlement Fail Penalty).

If the settlement instruction matches after the predicted settlement date, cash penalties are calculated and applied from the predicted settlement date. If the settlement instruction matches after the predicted settlement date, cash penalties for the period from the predicted settlement date until the working day prior to the matching date, will be calculated and charged to the party that last entered or amended the relevant settlement instruction in the settlement system.

If a transaction remains unmatched until the relevant cut-off of its intended settlement date (S day), CSDs will calculate and charge the late matching fail penalty (LMFP) on S+1 for only one day. If a transaction is matched on, for example, intended settlement date (S day), but after the relevant cut-off, or on an S+1 before the relevant matching cut-off, the penalty will also be calculated for only one day.

If a transaction remains unsettled on an intended settlement date (S day), OTP Banka d.d. will automatically release a *Daily Report on Cash Penalties for Settlement Fails and Late Matching (SEFP and LMFP) on DD.MM.YYYY. / ____ (portfolio name) ____.*

In case OTP banka d.d. receives cash penalties from the sub-custodian/CSD, the cash penalties report will be forwarded to the clients via e-mail on previously agreed e-mail addresses. If no penalties applied on a particular day, OTP Banka d.d. will not release an empty report.

If a transaction remains unsettled by the end of the settlement period on an intended settlement date (S day), but it settles overnight, SEFP penalty will be calculated and charged on the S day. If a transaction settles on S+1 before the end of the settlement cycle on that day, SEFP penalty will be charged on an intended settlement date (but not on S+1).

If a transaction settles on S+2 before the settlement cycle on that day, SEFP penalties will be calculated and charged for 2 days; on an intended settlement date and on S+1, but not on S+2. SEFP penalties will be charged for all blocked instructions (hold mechanism) for the following statuses: lack of cash and lack of securities, but if both instructions are on hold, both parties will be charged for SEFP penalty.

This scenario is not a zero-sum game in case of against payment settlement instructions, because the calculation method for settlement fails on deliveries against payment is different from the one on receipts against payments. Likewise, we stress here that the cancellation of a matched instruction subject to penalties will not lead to a cancellation of the penalties already reported.

You can find calculation methods with applicable rates and examples as an attachment to this Newsflash.

Calculation and allocation of LMFP and SEFP penalties

OTP banka d.d. will allocate net amounts of penalties (both LMFP and SEFP) to the clients' securities accounts and distribute the monthly penalty reports to the previously agreed e-mail addresses on the 14th working day upon receiving monthly penalty report from the sub-custodian/CSDs.

*Monthly Report on Cash Penalties for Settlement Fails and Late Matching (SEFP and LMFP) on DD.MM.YYYY. / ____ (portfolio name) ____ or a monthly MT537*** report* will contain:

1. the net amount of penalties that a client is to receive from the counterparty based on all the penalties in the previous month for all the instructions in the previous month, and
2. the net amount of penalties that a client needs to pay to a sub-custodian/CSD (subsequently to the counterparty), based on all penalties charged in the previous months for all instructions in the previous month.

Penalty payment currency for all transactions settled in SKDD and SKDD-CCP will be Croatian Kuna (HRK), whilst for transaction on other markets the penalties will be in the currency in which they were reported to OTP banka d.d. by the CSD or the sub-custodian. On a CSD level, the penalty currency for FP transaction will be expressed in a currency of the relevant financial instrument's reference price (for shares), or in a denominated currency of the instrument (bonds). If the aforementioned currency is not available in the CSD, the CSD will convert the currency in a default one of their choice.

After the distribution of monthly reports, and in accordance to the previously agreed clients' standing instructions and/or amendments to the Service Level Agreement, OTP banka d.d. will debit or credit transaction accounts for the penalty net amount by the 18th of the month. As default cash accounts for debit/credit payments, OTP banka d.d. will use cash accounts linked to the clients' securities accounts. On a request, there is a possibility of opening a new/additional cash account just for the purpose of cash penalties.

Appeal Period

OTP banka d.d. clients can submit an appeal on daily penalties calculated by the sub-custodian/CSD via signed memo on a group e-mail address settlement@otpbanka.hr or via MT599 message for clients who use swift channel. The latest deadline for appeal set at 8th business day of the month following the month of the penalty's detection. Appeals are expected to be appropriately documented, with clear reference to the disputed penalty, instruction reference and the reason for the appeal. Please note that disputes between the two parties of a trade shall be dealt with bilaterally, with no OTP banka d.d. involvement

Looking at CSDR rules, there are very few valid reasons for appealing, and a limited number of appeals vis-à-vis the CSDs are expected. However, if it happens, OTP banka d.d. will use the means made available by the CSDs or its sub-custodians to convey appeals downstream.

Accuracy of penalties

OTP banka d.d. will not check the penalty calculations and will pass through the calculation details when provided by CSDs and sub-custodians. Please note that reference price used by the CSDs will not be made public. OTP banka d.d. will pay particular attention to anything appearing to be outside the norm and will reconcile each and every received penalty with its underlying instruction in thy system. Any issue will be investigated immediately. For reconciliation purposes, OTP banka d.d. will undergo a monthly overview to confirm that the total penalty amounts reported in a monthly report are in line with the sum of the penalty amounts received on a daily basis.

You can find calculation methods with applicable rates and examples as an attachment to this Newsflash.

Penalties mechanism costs: the possibility of costs that might apply is still under consideration, depending on possible charges by the CSDs and sub-custodians (for example, the SKDD will introduce penalties mechanism costs).

Buy-in process

The SDR regime introduces a mandatory buy-in process aiming at closing the outstanding settlements through purchase of the missing securities by a third party (the "buy - in agent") or, as a last resort, through a cash compensation.

This new buy-in regime goes beyond the current buy-in process triggered by CCPs against failing clearing members, as it is applicable to all failing transactions (including OTC transactions).
Due to numerous challenges that market participants are facing with the buy-in process implementation, ESMA recommended to the European Commission the delay the buy-in rules until the **October 2022.**

Unlike the penalty process that primarily involves CSD participants and their failing settlement instructions, the buy-in obligation applies at first to the parties that concluded the deal the transaction originates from.

CSDR distinguishes three different buy-in cases, depending on the type of trade:

- for transactions cleared by a CCP, the CCP is the entity that executes the buy-in,
- for transactions not cleared by a CCP, but executed on a trading venue, the receiving trading venue member appoints a buy-in agent,
- for all other transactions, the receiving trading party appoints the buy-in agent.

CCP initiates the buy-in process for all transactions cleared by a CCP, but in other two cases aforementioned, the obligation and responsibility for launching the buy-in process falls on the parties receiving the financial instrument (i.e. the buyer).

This will have a significant impact on contractual agreements, as the sole responsibility to initiate and complete the buy-in process falls on the trading parties. CSDR does not anticipate an active role of central depositories, nor their liabilities in the buy-in process.

The scope of instruments subject to buy-ins is the same as the scope of instruments subject to penalties. Penalties incur for each day the instruction fails to settle until the actual settlement or cancellation date. Penalties are calculated at the level of the instruction, on an ad valorem basis (the rate depends on the type of financial instrument or on the currency) and using a reference price, which should be the same no matter the CSD in question.

The penalty collected/paid by the failing participant to the CSD will be distributed to the counterparty.

A buy-in is initiated at the point a settlement instruction has been failing far too long.

A period for initiating a buy-in depends on the type and liquidity of the financial instrument:

- 4 working days for liquid shares
- 7 working days for other instruments
- 15 working days for financial instruments traded on SME Growth Markets

FINANCIAL INSTRUMENT	EXTENSION PERIOD	BUY-IN PERIOD	DEFERRAL PERIOD
Liquid shared	4 days after intended settlement date	4 days	4 days
Other financial instruments	7 days after intended settlement date	7 days	7 days
Transaction on SME Growth Markets	15 days after intended settlement date	7 days	7 days

Not all instructions subject to penalties are in the scope of buy-ins; the delivering party must cause the fail. Settlement can fail due to a lack of securities, but also to any other reason preventing the delivery, like the instruction on hold ("hold and release" mechanism).

In addition, CSDR recognises the existence of circumstances that would make a buy-in not possible or ineffective and therefore admits specific exemptions. For example:

- a buy-in is not possible when the security no longer exists or when the failing trading party is subject to insolvency proceedings,
- a buy-in may be ineffective in the case of transactions composed of several opposite legs, typically repos.

When the duration of the repo is too short, it may happen that the buy-in related to the first leg cannot settle before the intended settlement date of the return leg. ESMA has thus set a minimum number of 30 business days between the two legs of the transaction. The existence of such exemptions reinforces the need to populate the field 'type of transaction" in the settlement instruction correctly and consistently with the information exchanged via the allocation.

A buy-in must be initiated at the end of an extension period (defined as the number of business days after the intended settlement date) that varies depending on the underlying instrument, with a specific rule for transactions executed on SME Growth Markets.

If the buy-in remains completely or partially unsuccessful after a buy-in period, the buying party has the choice to:

1. give up the buy-in: the fail is then resolved by a cash compensation paid by the selling party to the buying party,
2. extend the tentative buy-in for an additional period called the deferral period.

If still unsuccessful by the end of that period, the cash compensation applies.

Although the buy-in can be triggered by different parties (CCP, broker or buyer), the process will always follow the same steps. Before the buy-in is initiated, partial delivery must take place where possible: any party having opted out of partial settlement is now requested to accept any partial settlement and to update its instruction accordingly. Please note that this leads to cancellation of initial instruction and releasing new one(s).

Impact on Investors: implementation of measures to prevent settlement fails (cancellation mechanism, hold and release mechanism, recycle mechanism, partial settlement, tolerance level), and measures to address the settlement fails (cash penalties for late matching –LMFP, and cash penalties for late settlement – SEFP).

Required Actions: In order to prepare for the Settlement Discipline Regime, the following steps are recommended:

- review of the fail rates of transactions settlement with your brokers;
- review of operational processes and flows for weaknesses, inefficiencies and other flaws in relation to affirmation, allocation and transaction confirmation;
- review of the buy-in policies;
- decide whether or not to bear the costs of cash penalties (for LMFP & SEFP) on behalf of investment funds
- agree on new contractual arrangements with brokers in order to prevent and address settlement fails;
- agree on the monthly payment method for late matching/settlement penalties and consider the impact on the cash flow;
- engage a buy-in agent for possible buy-ins in the year 2022.

Application Date: 1 February 2022

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