FESE response to the ESMA CfE on shortening the settlement cycle

15th December 2023, Brussels

1. Impact of the reduction of the securities settlement cycle in the operations of market players

Q1: Please describe the impacts on the processes and operations from compressing the intended settlement date to T+1 and to T+0. Please:

1. Provide as much detail as possible on what issues would emerge in both cases and how they could be addressed with special attention to critical processes (matching, allocation, affirmation and confirmation) and interdependencies. Where relevant please explain if these are general or asset class/instrument/ trade specific.
2. Identify processes, operations or types of transaction or financial instrument class that would be severely impacted or no longer doable in a T+1 and in a T+0 environment.

Please, suggest if there are legislative or regulatory actions that would help address the problems. Where relevant please explain if these are general or asset class/instrument/ trade specific.

FESE Members are invested in achieving greater levels of competitiveness in the EU capital markets. The guiding principles for FMIs are to ensure efficiency, market stability, and investor protection when organising markets. In this context, exchanges are committed to supporting their customer base whenever they would be ready to move to a shorter settlement cycle.

FESE believes that a reduction of the settlement cycle from T+2 to T+1 should be closely coordinated among regulators, market participants, and Financial Market Infrastructures (FMIs). This reduction should also be preceded by a thorough analysis of settlement efficiency in the EU, weighing the impacts of a move to T+1 per asset class. Against this background, the EU should not lag behind and should try to explore the shortening of settlement cycles, so as to align with other third countries, in particular the US.

From a technical perspective, Trading Venues can potentially support any "T+n" settlement cycles (with an appropriate adaptation timeline). However, operational readiness can be challenging for some market participants. For instance, some are still working on ensuring readiness for T+2. In addition, smaller market participants in the EU would find it even more difficult to adapt their systems to a shorter settlement cycle. The transition would require proper time to allow the re-engineering of front and back-office processes by the entire value chain to allow a smooth compression of the settlement timelines without detrimental impacts in terms of market liquidity and settlement efficiency. In this context, it would be important to understand the status quo, particularly in terms of adaptation of manual and/or complex procedures.

FESE believes industry actors must collectively agree on "if, when and how" a transition to T+1 is operationally feasible and under which timeframe. Hence, while FMIs may already have the operational and technological capabilities to shift between different "T+n" in a shorter timeframe, reducing the settlement cycle might not yet be operationally feasible for their mixed customer base. Nevertheless, as said at the beginning, FESE Members are ready to support their customers and follow them if a shift to T+1 materialises.

For the reasons mentioned above, FESE believes it is important to maintain a high level of ambition to shorten the settlement cycle, but well balanced with operational efforts and risks to keep expectations close to reality. As such, analysis and proposals on how to shorten the settlement cycle should focus on a move to T+1, instead of T+0. While, in the long run, a move to T+0 could be foreseen, it is imperative to first solve the current challenges regarding T+1.

Q2: What would be the consequences of a move to a shorter settlement cycle for (a) hedging practices (i.e. would it lead to increase pre-hedging practices?), (b) transactions with an FX component?

FESE believes that problems could arise in the hedging/coverage of financial positions, with liquidity suffering. A shorter settlement cycle might widen the spreads and decrease overall liquidity, due to an increase in costs for market makers for providing securities. In particular, we foresee a mismatch in all trades in the US that require a currency hedge. Since the FX market is working with a T+2 settlement cycle, we also foresee an increase in risks and costs that must be assessed.

Consequently, the FX market is affected due to T+2 spot trading. T+1 trades are possible but not common and, therefore, more expensive.

Q3: Which is your current rate of straight-through processing (STP), in percentage of the number and of the volume of transactions broken down per type of transaction or per instrument as relevant? In case STP is used only for certain processes/operations, please identify them. Which are the anticipated challenges that you envisage in improving your current rate of STP?

N/A

Q4: Please describe the impacts that, in your views, the shortening of the securities settlement cycle could have beyond post-trade processes, in particular on the functioning of markets (trading) and on the access of retail investors to financial markets. If you identify any negative impact, please identify the piece of legislation affected (MiFID II, MiFIR, Short Selling Regulation…) and elaborate on possible avenues to address it.

In terms of trading activity, FESE is considering the spillover effects from the post-trade side on the trading side. There are reasons to believe that, as short-term effects, market makers will decrease trading activity/provision of liquidity in financial instruments where inventory risk is higher/costly. Examples would include the offering of an illiquid corporate or high-yield bond or, on the equity side, arbitrage option strategies involving shorting cash instruments such as shares. Whereas T+2 allowed the trading side one day to source the relevant instrument(s), a move to T+1 would mean the same instruments had to be sourced on t+0.

However, this on its own does not justify a shortening of settlement cycles. As mentioned above, market participants' readiness is the prime concern for market infrastructures. Responsibility relies on industry actors to collectively agree on "if, when and how" a transition to T+1 is operationally feasible and under which timeframe.

Q5: What would be the costs you would have to incur in order to implement the technology and operational changes required to work in a T+1 environment? And in a T+0 environment? Please differentiate between one-off costs and ongoing costs, comparing the ongoing costs of T+1 and T+0 to those in the current T+2 environment. Where relevant please explain if these are general or asset class/instrument/ trade specific.

From a technical perspective, Trading Venues can support any "T+n" settlement cycles. FESE expects medium to low costs for adapting the IT system to a shorter settlement cycle from a trading venue perspective. Some processes need to be adapted to shorter timelines (e.g. trading cancellation). Nevertheless, an appropriate adaptation timeline, agreed upon by all other industry actors, needs to be established beforehand.

Q6: In your view, by how much would settlement fails increase if T+1 would be required in the short, medium and long term? What about T+0? Please provide estimates where possible.

Settlement fails are likely to increase for EU ETFs on underlying markets traditionally with settlement windows longer than T+1. The end-users (buy-side) would have to bear extra costs from settlement fines. A potential solution is establishing "intended settlement in T+1" but allowing settlement discipline measures/penalties to kick in later in T+2 or T+3.

Q7: In your opinion, would the increase in settlement fails/cash penalties remain permanent or would you expect settlement efficiency to come back to higher rates with time? Please elaborate.

N/A

Q8: Is there any other cost (in particular those resulting from potential impacts to trading identified in the previous section) that ESMA should take into consideration? If yes, please describe the type of cost and provide estimates.

N/A

Q9: Do you agree with the mentioned benefits? Are there other benefits that should be accounted for in the assessment of an eventual shortening of the securities settlement cycle?

A move to T+1 would encourage all market participants to streamline their processes and fundamentally reduce manual processes. As a consequence, a move to T+1 will drive development and automation in EU capital markets industry.

Q10: Please quantify the expected savings from an eventual reduction of collateral requirements derived from T+1 and T+0 (for cleared transactions as well as for non-cleared transactions subject to margin requirements).

N/A

Q11: If possible, please provide estimates of the benefits that you would expect from T+1 and from T+0, for example the ongoing savings of potentially more automated processes.

N/A

Q12: How do you assess the impact that a shorter settlement cycle could have on the liquidity for EU markets (from your perspective and for the market in general)? Please differentiate between T+1 and T+0 where possible.

In terms of liquidity, since there are no real-time information flows between the trading, funding, and repo desks, secured funding desks rely on overnight maturity transactions. In case of any operational disruption, a liquidity trap might force a higher cash buffer maintenance, increasing the cost of business for banks and their clients. If it came to T+1,

banks would need to hold a larger amount of intraday as pre-funding needs will grow substantially due to faster settlement (in a T+1 world the liquidity would need to be held already in anticipation of new trades).

FESE Members are committed to ensuring efficiency, market stability, and investor protection when organizing markets. FESE also fully shares the general ambitions of MiFID II/R to increase trading activity in lit markets. For these reasons, it is crucial to ensure that a move to T+1 will not result in a shift of trading activity from regulated markets to bilateral trading. Without proper preparation and coordination prior to a move to T+1, some market participants might be forced to move their activities into the OTC space due to the impossibility of adapting certain settlement practices in a T+1 system. Liquidity would move away from lit multilateral trading because its post-trade environment cannot accommodate any more certain trading and post-trading practices. The public price-formation process would inevitably decrease in quality and representativeness. This reinforces the need to properly assess every asset class separately and avoid any rush in decreasing the settlement cycle, keeping a dialogue with stakeholders such as market participants. Therefore, FESE encourages policymakers to consider whether it is advisable to shorten the settlement cycle only for certain asset classes (e.g. equity instruments on T+1 but ETFs on T+2), and/or envisage a sequencing timeline for the adoption of T+1 by different asset classes.

Generally, FESE expects that trading activity, and the provision of liquidity, may be interrupted at least temporarily, especially in more illiquid and complex instruments.

Q13: What would be the benefits for retail clients?

We cannot see any specific benefits for retail investors.

From the perspective of bond markets, for example, the current system with T+2 settlements already works well.

Q14: How would you weigh the benefits against the costs of moving to a shorter settlement cycle? Please differentiate between a potential move to T+1 and to T+0.

With reference to a move to T+1:

Pros:

- Competitiveness: Maintaining the settlement cycle aligned with other major jurisdictions and avoiding that Europe falls behind.
- Enhance participation in capital markets: The EU move to T+1 has the potential (although allegedly overestimated) to bring in additional capital through the relief of collateral.
- Innovation: Technological solutions that will be developed in order to accommodate T+1 are welcome.

Cons:

- Settlement efficiency: Feedback indicates that settlement efficiency issues are already observed under T+2 and, supposedly, will tend to worsen with a move to T+1. The EU focus should first be on achieving settlement efficiency under T+2, which depends on the operational readiness and automation of front and back offices from the value chain. Root causes are not at the level of the settlement system.
- Settlement fails: Settlement fails are likely to increase for EU ETFs on underlying markets with settlement windows longer than T+1. The industry will have to bear extra costs from settlement fines. A potential solution is establishing “intended settlement in T+1” (understood in legal terms as “intended settlement date” under CSDR Art. 2(1)(12)) but allowing settlement discipline measures/penalties to kick in later in T+2 or T+3.

- Time zone: A high level of batch processing might lead to technical issues that may not be solved on trade date in some time zones. Furthermore, it is possible that working hours in the EU would need to be adjusted to accommodate the post-trading procedures taking place overseas under time pressure to respect the T+1 timeframe.

With regards to T+0, FESE believes that it is imperative to first solve the current challenges with reference to T+1.

2. How and when to move to a shorter securities settlement cycle

Q15: Please describe the main steps that you would envisage to achieve an eventual shorter securities settlement cycle. In particular, specify: (i) the regulatory and industry milestones; and (ii) the time needed for each milestone and the proposed ultimate deadline.

In terms of planning, the timeframe for the transition should be determined after looking at operational risk control and to the actual efficiency of EU markets. To this end, the transition should be planned in the mid-term. As stated, FMIs are overall ready and able to support any settlement cycle length and remain ready to support their clients, understanding that the complexity of shortening settlement timeframes might be higher for market participants.
In addition, FESE supports convergence whereby reduction from T+2 to T+1 should occur simultaneously for all EU markets, to avoid an increase in operational risk, and, ideally, in synchronisation with the UK.

Q16: Assuming that the EU institutions would decide to shorten the securities settlement cycle in the EU, how long would you need to adapt to the new settlement cycle? And in the case of a move to T+0?

Regarding the move to T+1, trading venues have the capacity to adapt their system in a relatively short timeframe. NCAs would need to actively participate in the testing phase. However, FESE would like to stress again that, while FMIs might already have the operational and technological capabilities to shift between different "T+n", reducing the settlement cycle might not yet be operationally feasible for their mixed customer base. Trading venues are inevitably subject to the trading needs of market participants. As mentioned before, FESE Members are ready to support their customers and follow them if a shift to T+1 materialises.

Q17: Do you think that the CSDR scope of financial instruments is adequate for a shorter settlement cycle? If not, what would be in your views a more adequate scope?

N/A

Q18: Is it feasible to have different settlement cycles across different instruments? Which are the ones that would benefit most? Which least?

As mentioned above, FESE would support further assessing the impact of a shorter settlement cycle per asset class.

Q19: Which financial instruments/ transaction types are easier to migrate to a shorter settlement period in the EU capital markets? Does the answer differ by asset class? Should it be feasible/advisable to have different migration times for different products/markets/assets? If yes, please elaborate.

With reference to repo transactions, it is worth noting that when financial markets moved from T+3 to T+2 in October 2014, the spot leg of repo trading was unintentionally covered. CSDR was never intended to apply to repo transactions and the ability to trade with a start date of T+3 or further forward. FESE recommends that any regulatory requirement to move to T+1 only covers cash trading (i.e. buy and sell), excluding repo trading.

Q20: Do you think that the settlement cycle for transactions currently excluded by Article 5 of CSDR should be regulated? If you think that the settlement cycle of some or all of these transactions should be regulated, what would be in your view an appropriate length for their settlement cycle?

N/A

3. International developments on settlement cycles and their impact on the Union's capital markets

Q21: Please describe the impact(s) that the transition to T+1 in other jurisdictions has had or will have on your operations, assuming the EU remains on a T+2 cycle.

With reference to the US move (May 2024), some operational challenges have been identified from a trading perspective:

- On dual-listed securities, there might be an impact on the prices available in the US/EU markets. In the US, ex-date and record date are aligned, whereas in the EU trading venues either have to keep ex-date (defined as record date minus one business day) or move the record date one business day after the US.
- On liquidity, spread and settlement efficiency needs to be monitored in particular concerning some asset classes where differences in settlement cycles might have a major impact (e.g. for ETFs).

Cross-border transactions with different settlement periods (T+1 vs T+2) would result in differences in pricing across the same product (due to different settlement periods), which could lead to the securities not being matchable anymore (buy vs sell match), or at least would increase funding costs to the trading desk (as when trying to match trades, one leg of the trade would have to be financed for one day. Since the liquidity provision could become more expensive for market makers due to the increased cost of securities lending, market spreads are expected to slightly widen, affecting trading activity as well. On the other side, risks taken on the balance sheet can increase because long positions would be bought T+1 and sold T+2. That could cause severe risks for settlement failures.

The current trading and post-trading system relies on internationally aligned settlement cycles. In the event the EU remains on a T+2 cycle, while critical financial jurisdictions (such as the US) decide to move to a T+1 cycle, there could be consequences for the attractiveness of EU capital markets. If traders and market participants from third countries adapt to a T+1 environment, they might tend to reduce their activities in those jurisdictions that still run on a T+2 cycle. For this reason, albeit only a qualitative assessment, and under the condition that the whole EU financial market industry is operationally and technically ready, FESE believes that the ideal scenario is to maintain settlement cycles worldwide aligned (whether on T+2 or on T+1). In the long term, it might be the case that the disadvantages of misaligned settlement cycles would outweigh the advantages of a more extended settlement cycle. Therefore, in order to maintain the attractiveness of European capital markets, ceteris paribus, it might be advisable to, sooner or later, move to T+1 (i.e. it is a question of "when" and "how" rather than "if"). To this end, the whole EU industry's involvement in the planning and readiness will be fundamental.

Q22: Can you identify any EU legislative or regulatory action that would reduce the impact of the move to T+1 in third countries for EU market participants? Please specify the content of the regulatory action and justify why it would be necessary. In particular, please clarify whether those regulatory actions would be necessary in the event of a transition of the EU to a shorter settlement cycle, or they would be specific only to address the misaligned cycles.

N/A

Q23: Do you see benefits in the harmonisation of settlement cycles with other non-EU jurisdictions?

Yes, FESE sees benefits in keeping settlement cycles among major jurisdictions aligned. In the scenario where the US adopts T+1 but the EU remains in T+2, we identified potential mismatch issues, competitive disadvantages as Europe falls behind new market practices, avoidance of EU markets for compliance reasons, and post-trade issues. If traders and other significant market participants from third countries adapt to a T+1 environment, they might reduce their activities in those jurisdictions that still run on a T+2 cycle. Under this scenario, trading financial instruments in the EU would become less attractive for overseas market participants, decreasing the overall liquidity and depth in EU capital markets. For this reason, and under the condition that all market participants are operationally and technically ready, FESE believes that the ideal scenario is to maintain settlement cycles worldwide aligned.

Q24: Would reducing the settlement cycle bring any other indirect benefits to the Capital Markets Union and the EU's position internationally?

N/A

Q25: Do you consider that the adaptation of EU market participants to the shorter settlement cycles in other jurisdictions could facilitate the adoption of T+1 or T+0 in the EU? Please elaborate.

N/A

Q26: Would different settlement cycles in the EU and other non-EU jurisdictions be a viable option?

We believe market participants and market infrastructures would, after some time, adapt to a two-tier system, differentiating between the different settlement cycles. However, as explained in the previous questions, FESE has identified the risk that some market participants located in a jurisdiction that operates under T+1 might reduce their activities in the EU if the T+2 system is kept. The ideal scenario, if conditions allow for it, would be to maintain a global alignment in settlement cycles.

Q27: Please elaborate about any other issue in relation to the shortening of the securities settlement cycle in the EU or in third-country jurisdictions not previously addressed in the Call for Evidence.

N/A