Shortening the settlement cycle in the EU

PANEL 1. What’s in T+1 for EU markets?

ESMA Public Hearing, 10 July 2024

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Alessandro Spolaore, Economics Financial Stability and Risk Department
Martijn Lathouwers, Central Counterparties Directorate
ESMA’s mandate

(a) Assessment of the **appropriateness** of shortening the settlement cycle
(b) Assessment of the **costs and benefits**
(c) **Detailed outline** of how to move to a shorter settlement cycle
(d) **Impact of international developments on EU market participants**

- Call for Evidence in October 2023
- Feedback Statement in March 2024
- Final report at the latest in January 2025
Key takeaways from the feedback received

- 81 replies received to the Call for Evidence
- Limited quantitative evidence
- Preference for T+1 over T+0 and consensus on “Big bang” approach
- Strong call for alignment in Europe (EU-UK-CH)

ESMA has continued its work, focusing on:

- Gathering further data to assess costs and benefits of shorter settlement cycles
- Identifying required steps to define the roadmap for the EU to reach faster and more efficient settlement
- Engaging with stakeholders (authorities, industry, retail investor representatives) in the EU and beyond
- Learning from international experience on T+1
Impacts of a shorter settlement cycle

Potential impacts on processes

- Eliminate delays at all steps of post-trade/pre-settlement processes
- Processes across chains of market participants and infrastructures
- Corporate actions processes
- Asset management issues incl. ETFs, subscription/ redemption cycles

Potential impacts on markets

- Trading practices
- Collateral management
- Inventory, liquidity and securities financing transactions

Preliminary market intelligence on impact of US T+1 move on securities lending activity

- Cash position management: FX transactions

Potential impacts on competitiveness

- More efficient markets and processes
- Alignment with T+1 markets
- Misalignment with non-T+1 markets, potential funding issues
Stable value on loan across classes

- Stable value on loan across asset types: No abnormal changes observed
- **Equity**: Slightly lower activity in week c. May 27th (-1.5% compared to May 2024 mean). Stable volumes compared to historical values (+0.4% on 1Q24). Higher activity in June 2024.
- **ETFs**: Minor increase in early June with respect to May 2024 average (+0.8%). Values on loan in week c. May 27th comparable to period before and after the move.

Stable utilisation rate

- **Definition**: Ratio of the number of shares on loan over the number of shares available for lending (i.e. the inventory of securities lending dealers). Utilisation rate represents the market demand to borrow a security.
- **Values comparable to historical levels**, no sudden shifts. **ETFs**: +1pp between May 28th and 29th (from 17.5% to 18.5%); however, values in line with previous levels.

Note: value on loan of securities issued in the US, by asset class, in EUR bn. The gray bar corresponds to 28th May 2024.
Sources: FIS Astec, Quandl, ESMA.

Note: Utilisation rate of securities issued in the US, by asset class. Utilisation rate in percent: the ratio of the market value of securities lent over the market value of securities available for lending. The gray bar corresponds to 28th May 2024.
Sources: FIS Astec, Quandl, ESMA.
Preliminary findings

Securities lending: market intelligence (2/2)

No changes in loan tenure (days)

- **Consistent tenure on average**
  - Broadly stable across asset types; no significant shortening of loan duration observed
  - **Equity**: Slight decrease in average tenure (-4%, from 98.5 days in May 2024 to 94.5 days in June 2024). Values in line with historical levels.

Stable loan rate, except for ETFs

- Broadly stable across asset types; no significant increase of loan fees observed. Overall, values comparable to historical levels: Average fee in June 2024 in line with 1Q24 average (+0.5%).
- **ETFs**: Minor increase in lending fees around end-May/early June (+6bps in first week of June 2024 compared to May average).

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Note: average tenure of loans for securities issued in the US, by asset class. Tenure is measured in days and weighted by the market value of the loan. The gray bar corresponds to 28th May 2024. Sources: FIS Astec, Quandl, ESMA.

Note: average cost to borrow for securities issued in the US, by asset class. Cost to borrow is an annualised rate that combines rebate rates for cash-backed loans and loan fees for non-cash-backed ones. The gray bar corresponds to 28th May 2024. Sources: FIS Astec, Quandl, ESMA.
Expected costs and benefits of a shorter settlement cycle

**Expected costs**
- Automation, IT upgrades
- Human resources
- Need for further standardisation, harmonisation of industry standards
- Potential increase of operational risk and settlement fails (and cash penalties)

**Expected benefits**
- Overall reduction of risks and related costs (clearing margins)
  - Shortening of settlement cycle expected to result in lower margins
- Eliminating costs created by misalignment with North America (including for funds and for dual listed securities)
- More efficient and competitive EU markets

- Not all costs and benefits are easy to quantify
- Potential uneven distribution of costs and benefits in the short term, but longer-term benefits for EU markets as a whole
Preliminary findings

Shortening of settlement cycle expected to result in lower margins (1/3)

- A potential benefit of T+1 settlement is the reduction of CCP margins, however the size of the margin savings across all CCPs and markets is not established with certainty
- ESMA requested additional information from CCPs relevant for the EU cash markets, using a dedicated questionnaire. Data has been collected from 11 CCPs. This data has been complemented with information received through the ESMA Call for Evidence issued in October 2023.

- The results suggest that the estimated size of margin savings based upon submitted CCP simulations amounts to approximately 2.7 bn EUR
  - Based on the feedback received, approximately 80% of savings are linked to cash equity markets with the rest of the savings for bond markets:
    - Average open positions may potentially be reduced by 47.3%
    - Average margins may potentially be reduced by 41.8%
    - Expected margin reduction up to 70% during expiries and days with high trading activity

1 Total amount is the result of a simulation of margin reductions using historical positions. Most CCPs performed this simulation over a 3 months period; one CCP only used 20 days. The percentage share of reductions in equity markets is taken from all the CCPs that have specified the margin savings per specific market. One large CCP has provided a contribution outlining a significant margin reduction (20% of total) but did not specify the relevant market.
Preliminary findings

Shortening of settlement cycle expected to result in lower margins (2/3)

Detailed view on margin reductions

- Reduction in positions is also expected to result in lower margins at relevant CCPs (ranging between 38% and 48%)
- Highest margin savings expected during trading days with expiries and high trading volumes
- No increase in daily margin calls in absolute terms expected
Preliminary findings

Shortening of settlement cycle expected to result in lower margins (3/3)

Potential impact on CCP risk management

- ESMA also requested input from CCPs on the impact of a T+1 settlement period on their respective risk management practices.
- Low level of expected failed transactions were reported by CCPs (max 5%), an increase in fail ratio would have limited impact on margin savings.
- Most CCPs outlined that no or minor impact is expected on its risk management practices. However, some attention points were raised:
  - Changes in stress testing results might lead to a review of default fund calibration.
  - Some CCPs outlined that intraday margin calls might need to be rescheduled or tweaked as to better account for settlement fails or intraday trading under T+1.
  - An adverse impact on CCP liquid resources could occur due to lower levels of collateral held, but liquidity needs may also reduce due to lower positions.
- Overall, no critical issues were reported by the relevant CCPs.
Panel 1. What’s in for EU markets?

• **Moderator:** Andrea Gentilini, CSSF, Head of Division Market Infrastructures and Chair of ESMA Post-trading Working Group

• **Panellists:**
  - Rosa Armesto (FESE)
  - Alexander Westphal (ICMA)
  - Rafael Plata (EACH)
  - Anna Kulik (ECSDA)
  - Vincent Ingham (EFAMA)
  - Aleksandra Mączyńska (Better Finance)
Thank you!
Shortening the settlement cycle in the EU
PANEL 2. A potential roadmap to T+1

ESMA Public Hearing, 10 July 2024

Antonio Ocaña Alvarez, Markets and Digital Innovation Department
A potential Roadmap to T+1 in the EU

Proposal for L1 amendment

European legislative process to amend CSDR

Potential ESMA L3 guidance

Publication Report on T+1

ESMA consultation L2

Submission to COM

L2 Legal review + Non-objection

Adoption L2

Industry definition of solutions to technical challenges

Industry Implementation

Testing (including Allocation, confirmation and matching on T0)

EU industry TF work

2025

2026

2027
Governance of the shift to T+1

Such a complex project calls for a specific and robust governance

Main characteristics:

• Has clear mandate and a timeline
• Includes all relevant parties and expertise
• Manageable in size
• One public authority in the lead towards implementation, after decision is taken
Poll on the deadline for T+1 in the EU

By when should the EU shorten the settlement cycle to T+1?

a) Q4 2027
b) Q1 2028
c) Q4 2028

[you are kindly invited to use the link in the chat to answer this question]
Poll on the deadline for T+1 in the EU

By when should the EU shorten the settlement cycle to T+1? **RESULTS**

- **Q4 2027**
- **Q1 2028**
- **Q4 2028**
Panel 2. A potential roadmap to T+1

- **Moderator:** Rodrigo Buenaventura, Chair of CNMV and of ESMA’s Markets Standing Committee

- **Panellists:**
  - Sebastijan Hrovatin (European Commission);
  - Marcello Topa (Citi, European Banking Federation);
  - Fiona van Echelpoel (ECB);
  - Jacqueline Mills (AFME);
  - Andrew Douglas (UK Technical Group)
Thank you!
ESMA Public Hearing – 10th July
Key Observations | US Move to T+1
Early data suggests that the US move to T+1 has driven sought after reductions in clearing fund requirements, while not resulting in material increases in fails across the industry.

DTCC analysis of industry Affirmation Rates shows that the move to T+1 has resulted in an increase in best practices, as firms affirm trades earlier on trade date.

<table>
<thead>
<tr>
<th>Overall Affirmation Rates</th>
<th>January</th>
<th>Post T+1(1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prime Broker Affirmation Rate</td>
<td>73%</td>
<td>94%</td>
</tr>
<tr>
<td>Investment Manager Auto Affirmation (Central Match) Rate</td>
<td>81%</td>
<td>98%</td>
</tr>
<tr>
<td>Custodian or Investment Manager (self) Affirmation Rate</td>
<td>92%</td>
<td>97%</td>
</tr>
</tbody>
</table>

Fails Rates remained broadly consistent with the May average under T+2, despite some concerns they might rise sharply.

<table>
<thead>
<tr>
<th>CNS Fail Rate(3)</th>
<th>May avg. (T2)</th>
<th>Post T+1(1)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.01%</td>
<td>2.30%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DTC Non-CNS Fails Rate</th>
<th>May avg. (T2)</th>
<th>Post T+1(1)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3.24%</td>
<td>3.30%</td>
</tr>
</tbody>
</table>

A significant decrease in Clearing Fund Requirements was realised, helping to enhance liquidity and mitigate risk for participants.

US$3.6bn

In a T+1 environment, the NSCC Clearing Fund reduced by >28% from past quarter average value of from US$12.8bn to US$9.2bn(4)

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(1) Average percentage over first 2 weeks of T1 go live up until 7th June
(2) Since T+1 go live 99% of CTM Allocations have been processed on average by 7:00pm EST on trade date, further illustrating the industry’s adoption of best practices
(3) Fails rates are based on value
(4) Average daily total from May 30th until 7th June
The US move to T+1 accelerated the drive towards Accelerated Settlement globally, with many best practice industry mandates, as well as regulations mandating T+1 settlement anticipated in the coming years across multiple jurisdictions.

- **U.S., Canada, Mexico, Argentina, Jamaica and Peru**: moves to T+1 May 2024
- **Australia**: has issued a White Paper and expects to announce a go-live date in Nov 2024
- **China**: transitions to T0 & T+1
- **India**: transitions to T+1
- **UK & E.U.**: both the Geffen Report and ESMA have called for closer cooperation and coordination between the UK and E.U. and Switzerland which should mean broader mandates
- **E.U. ESMA**: Expected to publish its report Q4
- **UK & E.U.**: Industry mandates in 2025
- **UK & E.U. & Australia**: Whilst the Geffen report encourages a UK go-live by the end of 2027, cooperation and coordination between the UK and E.U. may change this target. Other Asia markets may follow
- **Costa Rica**: proposes to transition to T+1 in 2025. Other Americas markets may follow
- **Australia**: has issued a White Paper and expects to announce a go-live date in Nov 2024
- **UK, E.U. & Australia**: - whilst the Geffen report encourages a UK go-live by the end of 2027, cooperation and coordination between the UK and E.U. may change this target. Other Asia markets may follow

~55% of Global Market activity is now settled T+1 – which could rise to ~85-90% by 2028.
Accelerated Settlement | US T+1 Key Observations

With the trend towards Accelerated Settlement globally, the US move to T+1 can provide a blueprint for other jurisdictions.

**SUGGESTED PATHWAY FOR SUCCESSFUL TRANSITION**

01 | Industry Collaboration

A period of **industry collaboration** before finalized regulations
- SIFMA, ICI, DTCC & the broker dealer / fund management communities partnered on executive summary report
- Should identify issues, craft solutions, define measures of success and shape timeframes as part of a proposed high-level roadmap

02 | Regulatory Mandate

Regulatory mandate is then imperative to drive commitment of resources and uniform compliance with multiple tasks required. All timeframes to ensure success are dependent on Regulatory certainty

When issuing mandates, regulators should consider the impact of proposed timeframes and coverage of client segments

03 | Global Coordination

Consider opportunities to drive global consistency. Acknowledge impacts **beyond your direct control and engage early**, as this can have broader global impact on the rules and/or to other processes e.g. misaligned settlement cycles for American Depositary Receipts (ADR)/ Exchanged Traded Funds (ETFs), FX and Stock Lending

04 | Engagement and Education

Ongoing engagement with, and education for, the industry
- Knowledge Sharing resources (e.g. initial Implementation Playbook, Detailed Testing Framework and dynamic library of materials maintained on UST1.org)
- Regular industry readiness calls, client tabletops, educational webinar, panel discussions and client outreach throughout the lifecycle of the initiative

The move to T+1 can act as a catalyst for post-trade modernisation, allowing market participants to obtain resource & budget to increase settlement efficiencies

**CRITICAL ENABLERS FOR SUCCESS**

**RESILIENCY**

- **CENTRAL MATCHING**
  - Include additional data such as Place of Settlement (PSET)

- **USE OF ELECTRONIC STANDARD SETTLEMENT INSTRUCTIONS (SSIs)**
  - Use of a fully-reconciled golden-source SSI repository

- **INVENTORY MANAGEMENT**
  - Repositioning Inventory earlier helps accelerate overall process

- **INCREASED STANDARDIZATION**
  - Unique Transaction Identifiers (UTIs)
MISALIGNMENT OF SETTLEMENT CYCLES

- CORPORATE ACTIONS ON MULTI-LISTED SECURITIES

10 July 2024
What is the problem?

- To facilitate operational processing, the sequence of key dates for a corporate action is determined by the settlement cycle.

- If a security is traded on two separate trading venues with different settlement cycles, then for a corporate action on that security there is a choice between:
  - A single, common set of corporate action dates - but with the disadvantage that these dates shall be operationally inappropriate for securities traded on one of the venues; and
  - Two different sets of corporate action dates - but with the risk of confusion and operational errors.

- Different corporate action dates for the same security may affect, amongst other things:
  - Pricing of the security
  - Pricing of derivatives
  - Eligibility to participate in a corporate action
Discussion of possible solutions

▪ **If two sets of corporate action dates are used**, then there would be a need for a rigorous segregation between the securities traded on one trading venue, and the securities traded on the other trading venue.

▪ This segregation:
  o Should include the use of different securities identifiers (ISINs); and
  o Needs to be effective at all levels, including the issuance, listing, trading and custody of the securities.

▪ **This rigorous segregation is not always possible**. There are many cases of multi-listed securities that have, for example:
  o One ISIN, and/or
  o One single issuer CSD.

▪ Multi-listed securities can be very diverse, with very different regulatory, operational and fiscal arrangements.

▪ The **specific choice** (one set of dates, or two sets of dates) for a specific security **may well depend on specific features of the trading and operational set-up** of that security.
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