ECMI EUROPEAN CAPITAL MARKETS INSTITUTE

ECMI Commentary no 77 | January 2022

Shortening the settlement cycle

Why Europe should not wait too long to introduce T+1*

Apostolos Thomadakis**

The amount of time required for the settlement of securities is a long-running issue for European capital markets. Twenty years ago, the Giovannini Group looked at the large number of securities settlement systems that existed in Europe (and still do). In 2014, based on the Group's proposals for improving the settlement cycle, the EU moved from T+3 (trade date plus three business days) to T+2 (trade date plus two business days), with the US following a few years later in 2017. The US is now ready to shorten its settlement cycle further to T+1 by 2024, and the question of whether the EU should follow cannot be ignored for too much longer. However, the significant problems caused by the diversity and fragmentation of the EU's capital markets and market infrastructures would have to be solved first.

Background

In 2001, the Giovannini Group highlighted the need to harmonise settlement periods across the EU (barrier 6)[1]. At the time, with the exception of Germany, which had a settlement period of T+2, EU markets (in particular equity) had a settlement period of T+3. The benefits of harmonising the settlement period to T+2, it was argued, would be to bring equity markets into line with the foreign exchange market (which was largely settled at T+2 at the time, and in some cases even at T+1). It would also improve efficiency, reduce settlement risk and collateral, and remove barriers between borders[2]. As a result, in October 2014, the central securities

**This commentary builds on discussions from 'Settlement cycle: Should it stay (T+2) or should it go (T+1)?', an ECMI webinar held on 15 December 2021.*

***Apostolos Thomadakis, PhD, is a Researcher at ECMI and CEPS.*

[1] Giovannini Group (2001), 'Cross-border clearing and settlement arrangements in the European Union', Brussels, November, https://ec.europa.eu/info/sites/default/files/first_giovannini_report_en.pdf.

[2] These considerations were also highlighted in the Group of Thirty (G30) Recommendations: G30 (1988), 'Clearance and Settlement Systems in the World's Securities Markets', New York & London, https://group30.org/images/uploads/publications/G30_ClearanceSettlement1988.pdf; Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems (2001), 'Recommendations for Securities Settlement Systems', https://www.bis.org/cpmi/publ/d42.pdf; and G30 (2003), 'Global Clearing and Settlement: A Plan of Action', https://group30.org/images/uploads/publications/G30_GlobalClearingSettlement.pdf.

depositories regulation (CSDR) mandated 29 European markets[3] to move from a T+3 to a T+2 settlement cycle[4], in a 'big bang' migration unprecedented in terms of scale.

The shortening of the US settlement cycle to T+2 took place in March 2017[5]. The US now aims to accelerate the settlement cycle even further, to T+1, by the first half of 2024[6]. There are two main reasons for doing this.

First, modernising transaction flows will reduce inefficiencies within the marketplace and improve efficiencies for capital and liquidity requirements.

In the case of capital efficiency, for example, there is a cost associated with the duration of the trade being open. Shortening the settlement cycle by removing one day of risk reduces the uncertainty associated with it. According to estimates, the reduction of one day's exposure of risk could be translated into a potential average reduction of margin (i.e. clearing fund) of 41 % (DTCC, 2021).

The second reason concerns the impact of the Covid-19 pandemic[7] and the need for automation. Shortening the settlement cycle reduces the time for something to go wrong, but it also reduces the time to fix things if something does go wrong. The market turmoil and the volatility of the global financial markets observed at the start of the Covid-19 in early 2020 highlights the need to increase automation and resiliency in the financial services industry. This would eliminate inefficient and manual processes and increase the scale and speed of processing, as well as reducing risks and lowering costs.

It is therefore vital that, as the work is done to advance the cycle and transition to T+1, as many of the areas that need to be addressed are as automated as possible. One of the drivers of failed trades in the US market is information inefficiencies (e.g. incorrect settlement instructions, wrong account numbers and custodian names)[8]. A strong T+1 settlement cycle needs automated tools.

---

[3] The 29 markets that moved to T+2 on 6 October 2014 were: AT, BE, CY, CZ, DK, EE, EL, ES (for bonds), FI, FR, HR, HU, IS, IE, IT, NL, LI, LT, LU, LV, MT, NO, PL, PT, RO, SK, SE, CH, and UK. BG, DE and SI were already settling on a T+2 basis.

[4] Settlement has to take place no later than the second business day after trading for transactions in transferable securities executed on a trading venue (Article 5(2) CSDR).

[5] US Securities and Exchange COMMISSION Press Release (2017), 'SEC Adopts T+2 Settlement Cycle for Securities Transactions', 22 March, https://www.sec.gov/news/press-release/2017-68-0.

[6] It is worth bearing in mind that there is a very active T+1 foreign market today. Currently, the US Treasury market settles on T+1, while the UK yields market at T+0.

[7] For example, in the first half of 2020, DTCC experienced four new highs on trading volumes (i.e. transactions processed). This resulted to a large increase in the clearing fund that clients needed to pay. See DTCC (2021), 'Advancing Together: Leading the Industry to Accelerated Settlement', February, https://www.dtcc.com/dtcc-connection/articles/2021/february/24/advancing-together-leading-the-industry-to-accelerated-settlement.

[8] According to BNY Mellon data, information inefficiencies account for approximately 23 %, with the remaining 77 % being due to a shortage of securities. In Europe, the Settlement Discipline Regime (SDR) – a central aspect of the CSDR that introduces measures to prevent and address settlement fails – will enter into force on 1 February 2022. See for example 'Joint Trade Association Letter regarding Implementation of the CSDR Settlement Discipline Regime' 11 March, https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/CSDR-Settlement-Regulation/Joint-Trade-Association-Letter-regarding-Implementation-of-the-CSDR-Settlement-Discipline-RegimeFinal-110321.pdf.

The securities lending market is one area where a shortening of the settlement cycle would bring challenges. According to International Securities Lending Association (ISLA), the estimated value of securities on loan globally was about EUR 2.6 trillion in June 2021, with the US accounting for about 57 % and Europe around 25 %[9]. Despite the availability of automated tools, a lot of securities lending is still happening via email or phone. A move to T+1 will require the securities lending process, and in particular the recall of securities, to be done in a much more expedient manner. Otherwise, there will be delays and possibly failures in the transactions related to the securities lending process.

A move to T+1 will also have an impact on the allocation and affirmation process of transactions. Trade allocation is the process by which an asset manager determines and informs the seller(s) and the custodian(s) how and to which account(s) to assign the securities that have been traded. Trade affirmation is the process that occurs after a trade is executed, whereby counterparties verify and affirm the details of the trade before submitting it for settlement. The transition to T+1 could be made much easier for this rather cumbersome allocation-affirmation process[10] by taking full advantage of automation.

Furthermore, a shortening of the settlement cycle from T+2 to T+1, will match the current settlement cycle of mutual fund shares. Today in the US, most of the mutual fund shares trades are settled a T+1. By reducing the settlement cycle to T+1 on the portfolio side, there will be a perfect alignment between the activity on the portfolio and the activity on the mutual fund share side. This alignment in the cash management process allows the portfolio manager to react more quickly to changes in the market.

An aspect that should not be ignored is the difference in scale between moving from T+3 to T+2 and from T+2 to T+1. The latter transition is significantly more radical because of the shorter timescale between the trade date and the settlement date. Essentially, and because most central securities depositories (CSDs)[11] operate at night, a move to T+1 from an operational perspective would mean that there are significantly less hours between trade date and the beginning of the settlement cycle for the post-trade operational process.

What should Europe do?

Should Europe follow if the US moves to T+1? The answer is yes, Europe should follow. First, there are clear benefits to a shorter settlement cycle. Second, the US will have proved that it is possible, so there will be no reason for Europe not to do it. Third, European and US markets are interlinked and interdependent in several distinct ways, either directly or indirectly (e.g. CSDs

[9] ISLA (2021), 'Securities Lending Market Report', 15th Edition, June, https://www.islaemea.org/assets/smart-pdfs/isla-securities-lending-market-report-june-2021/files/downloads/2516_21_June_ISLA_Market_Report_-_June_2021_-_final.pdf.

[10] This is by reducing trade failures, adding efficiency and transparency, improving data management, reinforcing internal audit protocols and bolstering risk management. See DTCC (2020), 'It's Time for a Post Trade Upgrade: Automation is Critical in Reducing Trade Fails', October, https://www.dtcc.com/dtcc-connection/articles/2020/october/01/its-time-for-a-post-trade-upgrade-automation-is-critical-in-reducing-trade-fails.

[11] CSDs are the key institutions that operate the infrastructure – the securities settlement systems – that enable settlement. They are the institutions that materialise the transactions concluded on the markets.

and settlement systems are connected though technical or account relationships)[12]. Foreign exchange, for example, is settled in T+2[13]. Thus, a move to T+1 for US dollars – the world's most frequently used currency – will have a significant impact on global markets (e.g. in terms of settlement risk, collateral, and liquidity risk)[14].

But it is important to consider the preconditions under which Europe would move. It is a long-term endeavour and not something that can be introduced immediately. It requires changes in the settlement process and regulation that involves a range of market participants and market infrastructures, and without adequate preparation there would be significant risks.

First, the national central banks within the Eurosystem would have to move to the new collateral system[15]. Second, the EU has 24 CSDs and two 'international' CSDs (ICSDs)[16] authorised by ESMA[17]. While the move to T+1 could happen quite quickly for ICSDs, it is a much more complex issue for CSDs, requiring great coordination between the involved stakeholders (e.g. CSDs, national central banks, the ECB, regulators and supervisors). Third, because of the diversity of market infrastructures, while some will certainly manage T+1, others will struggle. This will require a major outreach exercise to ensure a smooth transition. Fourth, regulation may also have to be adapted accordingly in a way that accommodates rather than hinders a short settlement cycle[18].

The way forward

Given that Europe will inevitably have a coordination challenge to overcome, and one that cannot be solved quickly, there are two steps that should be implemented sooner rather than later. The first is to kick off the discussion and gather views from all different relevant stakeholders (e.g. CSDs, buy and sell side, regulators, central counterparty clearing houses, and other types of market infrastructure). The pan-European industry associations (e.g. the European Banking Federation, the Federation of European Securities Exchanges, and the European Central Securities Depositories Association) could lead this process. The second step is to conduct a feasibility study, including an assessment of the challenges that need to be overcome, as well as the necessary preconditions for a move to T+1. Such an endeavour will take time, so let's kick off the discussion immediately.

---

[12] Committee on Payment and Settlement Systems (CPSS) (2008), 'The Interdependencies of Payment and Settlement Systems', June, https://www.bis.org/cpmi/publ/d84.pdf.

[13] Although there are exceptions, with some currency pairs already settled on T+1 (e.g. USD/CAD, or USD/TRY).

[14] Foreign securities and foreign exchange do indeed create a major issue. There is no silver bullet, and a lot depends on the many factors and players that need to be in sync.

[15] The Eurosystem Collateral Management System (ECMS), which is to be launched in November 2023, will be the new common system for managing assets used as collateral in Eurosystem credit operations. It will replace the existing 19 individual collateral management systems of the euro area national central banks. The ECMS is expected to foster harmonisation of collateral management practices and to contribute to financial integration in the EU.

[16] These are a sub-category of CSDs specialising in the issuance of international bonds, commonly known as 'eurobonds'. The two ICSDs are Clearstream Banking in Luxembourg and Euroclear Bank in Belgium.

[17] See the list of EU CSDs authorised by ESMA under Art 16/Art54 of CSDR.

[18] For example, operational practices that are built on legacy legal and regulatory structures, such as those related to registered shares in some countries. Many of the legacy practices are already problematic; in a T+1 environment they will be much more so.

European Capital Markets Institute

ECMI conducts in-depth research aimed at informing the debate and policymaking process on a broad range of issues related to capital markets. Through its various activities, ECMI facilitates interaction among market participants, policymakers and academics. These exchanges are fuelled by the various outputs ECMI produces, such as regular commentaries, policy briefs, working papers, statistics, task forces, conferences, workshops and seminars. In addition, ECMI undertakes studies commissioned by the EU institutions and other organisations and publishes contributions from high-profile external researchers.

Centre for European Policy Studies

CEPS is one of Europe's leading think tanks and forums for debate on EU affairs, with an exceptionally strong in-house research capacity and an extensive network of partner institutes around the world. As an organisation, CEPS is committed to carrying out state-of-the-art policy research that addresses the challenges facing Europe and maintaining high standards of academic excellence and unqualified independence and impartiality. It provides a forum for discussion among all stakeholders in the European policy process and works to build collaborative networks of researchers, policymakers and business representatives across Europe.

European Capital Markets Institute, Place du Congrès 1, 1000 Brussels, Belgium
www.ecmi.eu, ecmi@ceps.eu