T+1 Settlement Considerations

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Background

Settlement is an essential and critical step in the securities trading lifecycle – whereby the buyer receives the purchased securities, and the seller receives the corresponding cash in exchange for those securities. This underlying concept is similar to that of any commercial transaction ranging from store purchases to property sales. However, in the case of securities transactions, the settlement process does not occur simultaneously with the execution of the trade. There is a window between trading and settlement which allows for several important processing steps to take place which ensure a high degree of control and assurance, necessary for processing large volumes and values of securities transactions. Over time, advancements in technology along with standardization (often regulatory driven) across market structures have allowed for this window to be reduced.

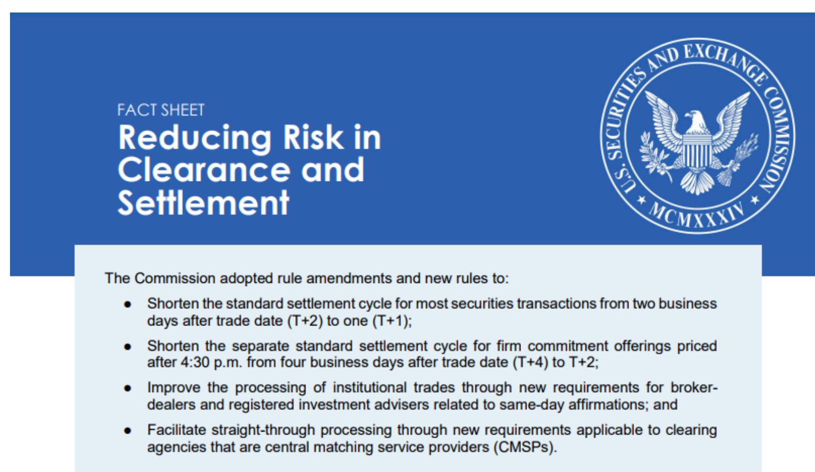
Recent settlement developments

Currently, most securities transactions executed on a trading venue in relation to European markets settle on a T+2 basis – i.e., the window between the trading date and the settlement date is 2 business days. This has been the case since October 2014, when a majority of European markets simultaneously adopted T+2 in preparation for the direct application of Article 5 of the EU Central Securities Depositories Regulation (CSDR). By shortening the cycle, European legislators aimed to standardize settlement processes across EU securities markets and accordingly to reduce counterparty and market risk.

The developments seen in Europe were followed by the US implementing a similar move from T+3 to T+2 a few years later in 2017. The successful transition from T+3 to T+2 was a significant undertaking for market participants across both Europe and the US. Although standard settlement cycles effectively changed overnight, this was the result of several years of planning, testing and coordination across the industry. The Association for Financial Markets in Europe (AFME) played an active role in helping European market participants prepare for the change, which naturally had significant impact across front, middle and back offices.

Moving towards T+1

In recent years, we have seen a number of jurisdictions, particularly in Asia and North America, explore and even actively pursue the shortening of settlement times even further to T+1. In February 2022, India commenced a phased approach to migrating its markets to a T+1 settlement timeframe with this process completing in January 2023. This was subsequently followed by Canada and the US who appear to be taking a different stance and will seek a wholesale adoption and implementation of T+1 to their markets at certain dates in the future. The latest publications from SEC indicate that T+1 will be launched in the US markets in May 2024 – effectively in a year's time. The region not represented in this global movement as yet is Europe and therefore it is worth considering whether it is appropriate and / or beneficial for Europe too and, if so, how this could be achieved.



FACT SHEET

Reducing Risk in Clearance and Settlement

U.S. SECURITIES AND EXCHANGE COMMISSION • MCMXXXIV •

The Commission adopted rule amendments and new rules to:

- Shorten the standard settlement cycle for most securities transactions from two business days after trade date (T+2) to one (T+1);
- Shorten the separate standard settlement cycle for firm commitment offerings priced after 4:30 p.m. from four business days after trade date (T+4) to T+2;
- Improve the processing of institutional trades through new requirements for broker-dealers and registered investment advisers related to same-day affirmations; and
- Facilitate straight-through processing through new requirements applicable to clearing agencies that are central matching service providers (CMSPs).

In the following sections, we will endeavor to provide some initial insights on what the potential benefits and challenges of T+1 securities settlement could represent and to set out some key considerations for T+1 implementation. Given the high degree of integration in these capital markets, we believe that most of the considerations set out here can apply equally to the EEA, UK and Swiss markets.

Benefits Of Moving To T+1

A shorter settlement window reduces risks to the financial system. The less time it takes for cash and securities to change hands after a trade is agreed, the slimmer the chance of a counterparty defaulting or failing to meet its obligations.

Additionally, halving the settlement period would also decrease the time market participants need to hold capital and post margin at clearing houses to cover open exposures. This reduced burden would free up capital and help market participants trade more efficiently and this is particularly relevant during volatile periods. The move to T+1 would also help streamline settlement, limiting delays and fails. For example, trade affirmations would need to be communicated and verified on the trade date, reducing the chance of errors over the long term.

Lastly, the US rules will likely accelerate the global move towards T+1 settlement and Europe following suit would help its financial markets remain competitive on the world stage.

Potential Risks

The impact of a shortened settlement cycle will vary across products and asset classes and will be more pronounced for some rather than others. Notably, current settlement failure rates for transactions in ETFs are above market averages. This is in part due to the global composition of many ETFs, which contain underlying securities from multiple jurisdictions. Given the fact that settlement of newly created units is contingent on the settlement of the underlying constituents, this can often lead to settlement delays in a T+2 environment with the impact of time zone differences, market holidays and cross-border settlement complexity. These challenges would be even more acute in a T+1 environment. Moreover, overlaying the dynamic of the FX markets running on T+2 cycle, the inherent complexities become increasingly more evident.

Another consideration is that there would be less time available to resolve processing errors. This includes a shorter window for sourcing liquidity from the securities lending market to cover short positions, which could be particularly impactful when sourcing less-liquid bonds and stocks. For example, firms doing short sales late in the trading day will have little time to locate the securities needed to cover their positions. This could be particularly relevant for illiquid stocks/bonds or where borrowed securities and short-sale transactions are located in different depositories. The US market which operates with a single currency and unified regulations and thus effectively is a single market means managing these challenges is a lot easier for market participants. Unfortunately, the same cannot be said for Europe which is a continent of 35 exchanges, 31 central securities depositaries (CSDs) and 14 local currencies.

Key dates and market practices in relation to corporate actions will need to be reviewed and updated where applicable. General market practice for the sequencing of key dates in the corporate action process is that Ex Date should precede Record Date by the settlement cycle minus one business day. This process works well in a T+2 settlement cycle, and allows a business day between Ex Date and the Record Date and then the Pay Date. This has resulted in an almost complete eradication of reverse market claims, which take place when trade date is on or after Ex Date and Actual Settlement Date is on or before Record Date. If Europe moves to a T+1 settlement cycle, key dates would have to be similarly updated, so that Ex Date equals Record Date. Failure to do this could potentially result in a significant increase reverse market claims.

Cautiously Forward

The impact of a move towards T+1 needs to be seriously and comprehensively analyzed and coordinated by global regulators as it could lead to an increase in late or failed trades. This could result in significantly greater costs for market makers due to buy-in costs or late settlement penalties under CSDR. These costs may lead to wider prices and or smaller sizes. Moreover, the unique nature of ETFs and the ETF ecosystem should also be a major consideration as part of this overall analysis. A practical approach that could be considered would be for a harmonized buy-in exemption/extension for market makers at least on a temporary basis, which could alleviate some of the liquidity concerns around the creation redemption process. Indeed, already the current plans to move to T+1 in the US while Europe remains at T+2 could potentially skew pricing given likely funding costs for relevant affected ETFs. Any potential impacts are not limited solely to market makers but also other critical members of the ecosystem such as issuers who have also expressed concerns around mismatched settlement cycles and adequacy of underlying infrastructure in Europe.

From our standpoint, these are vitally important considerations that should be at the forefront of deliberations by European legislators and regulators rather than seeking to equivalate with other jurisdictions in as rapid a timeframe as possible. Therefore, when it comes to modifying settlement rules, it is advisable to proceed with caution given the pivotal role settlement plays across the entire securities trading lifecycle.

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