Amafi ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

TOWARDS A SUCCESSFUL MOVE TO T+1

A SPECIFIC APPROACH FOR BONDS AND ETFS

In preparation for the future EU legislative agenda, the European Commission is considering a number of reforms to develop the EU capital markets and make them more competitive, including in the post-trade environment. In this context, the decision has been taken at the political level to shorten the settlement cycle in the EU to T+1, following the UK's decision and the recent successful move by several Asian (o/w India) and American jurisdictions (USA, Canada and Mexico notably).

AMAFI supports the EC's initiative to move to T+1 in order to maintain the attractiveness of EU markets. It is extremely important that the transition is a success, as any failure would jeopardise Europe's credibility and could affect the depth and liquidity of its markets.

With this objective in mind, it is critical to remember that the post-trade in the EU is much more fragmented than in other jurisdictions and that the ecosystem of market participants and market depth are quite different in certain market segments, making the project much more difficult, riskier and undoubtedly more costly than in the US.

In particular, care should be taken to ensure that T+1 is not achieved at the expense of the liquidity of European markets and their ability to finance the economy, which would run counter to the objectives set out in the recent reports by Enrico Letta and Mario Draghi. **Care should also be taken to ensure that small and medium-sized players, which serve SMEs and innovative companies in the EU, are not excluded from the market by the level of investment required. These entities, particularly in segments such as corporate bonds and illiquid securities, could face a disproportionate impact compared to larger banks or buy-side institutions.**

On 14 October, the European T+1 Industry Task Force published a roadmap for the introduction of T+1 in securities markets, highlighting the complexity of the exercise in the EU, which will require significant efforts from all sides. While further in-depth impact analysis is required, the report suggests that once a firm decision has been communicated, a transition period of between 24 and 36 months will be required, reflecting the complexity of the capital markets landscape in Europe.

AMAFI agrees that this complexity needs to be reflected in the relevant timelines of the project, so that an EU move to T+1 in 2027, possibly at the same time as the UK, while desirable in theory, may not be practicable in reality. A good balance must therefore be struck between the feasibility of the European project and the disadvantages of a period of misalignment with the UK market.

In these circumstances, and with a view to the success of this project, the following points should be considered.

I. Setting up a public/private task force

Given the enormous complexity of this project, its geographical scope and the large number of stakeholders involved (mainly sell-side, buy-side, issuers, market infrastructures, regulators, central banks, public institutions), it is essential and urgent to set up a governance structure, as announced by the EC, ECB and ESMA in their joint statement of 15 October 2024: "*in close coordination with national competent authorities, DG FISMA and the ECB's DG MIP have therefore agreed to establish a governance structure, incorporating the EU financial industry, as soon as possible to oversee and support the technical preparations of any future move to T+1*".

This governance structure should ensure a fair representation of the different public and private sector stakeholders. It is also necessary that the private sector can be represented not only by European trade associations, but also by interested national trade associations, such as AMAFI and France Post-Marché, which have a direct and precise knowledge of their national markets and their specificities (e.g. *nominatif administré* status or shareholder identification process in France). We note that the European T+1 Industry Taskforce has so far not taken into account national specificities in its analysis, while the understanding and inclusion of such specificities will be paramount for the success of the future project.

We understand that, in the advice that it is to publish by the end of the year following the consultation that was run in Q4 2023, ESMA will propose a date for the move to T+1 in advance of the work to be overseen by the governance structure.

However, we believe that the exact date of the transition should not be imposed to the governance structure but be determined by it on the ground of its detailed assessment of the tasks to be performed and the time required to complete them, taking into account their interactions and the necessary testing periods. With this in mind, we believe that the first task of the governance structure should be to determine, no later than June 25, a practicable transition date. Such an approach would allow market participants to budget their projects for the following years.

II. Bonds and ETFs – Specific market practices calling for a specific approach

The move to T+1 clearly requires technical changes throughout the production chain, from trading to settlement.

But, for certain market segments, the success of the project also depends to a large extent on changes in the behavior and market practices of market participants.

At this stage, we have identified at least two market segments, bonds and ETFs, which present specific features in terms of functioning that the transition to T+1 could disrupt significantly and cannot be solved only by the adaptation of settlement systems and processes[1].

A. Bonds – the liquidity issue

The bond market is particularly prone to settlement failures due to:

- The difficulty in locating the bonds and transfer the positions between national CSDs and ICSDs to ensure final settlement.
- The need to source liquidity, which is not always available in the quantities or under the timeframe required (a more acute problem for corporate bonds).

As for the first point, specific attention will need to be directed at how to resolve this issue, which will require not only technical changes but also a change of market practices, for the two main following reasons:

- The use of local custodians is more developed for bonds than for equity, making the location of the positions difficult in a timely manner;
- Fails can be a lot more impactful due to the size of the trades (especially for government bonds), exacerbating the problem.

As for the second point, the **bond markets** rely on market makers who are the only ones able to satisfy investors' need for immediacy. To do so, market makers do not only accept client transactions in securities they hold in their inventory. They therefore need to be able to borrow these securities to allow the client transaction to settle. This is done mainly through Repos and, in a lesser extent, securities borrowing and lending, i.e. Securities financing transactions (SFTs).

The SFT market for EU bonds has the following features:

- It is almost fully GMRA[2], with more than 90% of transactions taking the form of cash vs securities Repos (as opposed to Securities Lending),
- Repos are concluded for one day, and market participants who need to cover a short over a longer period roll their Repo each day over that period,
- There are several time conventions for Repos:

	Trade date	Start date DVP initiation	End date DVP return
O/N (Overnight)	T	T+0	T+1
T/N (Tomorrow Next)	T	T+1	T+2
S/N (Spot Next)	T	T+2	T+3

[1] We have also identified issues linked to the recall process of equities lending, which is intricately linked to the market participants and could significantly hurt liquidity, however we will address this issue in more detail at a later stage.
[2] Meaning that it is organized by ICMA's Global Master Repurchase Agreement

To be effective, Repo transactions need to be carried out in a shorter timeframe than the "cash" transactions to which they relate, i.e. currently Overnight or Tomorrow Next. This explains why settlement fails remain more frequent for bonds, even after the implementation of CSDR. For T+1 to happen on cash transactions, the settlement of Repos will then have to occur at T+0, i.e. the market will need to shift massively to the Overnight convention.

This is problematic, as liquidity is presently almost non-existent at T+0 in the EU. The European Repo market has not yet fully integrated the transition from T+3 to T+2: liquidity is currently divided equally between Tomorrow Next and Spot Next), showing that the adaptation to T+2 is still in progress in Europe.

- For **government bonds**, the European overnight Repo market remains underdeveloped with scarce overnight liquidity, contrary to the US and the UK where there is a high concentration of overnight liquidity. The US Repo market differs indeed in terms of the size of money market funds and the regulation applying to them since 2017. These make for a stable and abundant source of overnight refinancing.
- In Europe, the money market fund industry is less developed and regulation limits liquidity for same-day refinancing. The interbank repo market currently provides liquidity but not always with the necessary volumes and without allowing same-day hedging, as this would require complex management to balance cash holdings and refinancing (or the imposition of earlier cut-offs on clients, which is not an option). Even within an ideal ecosystem that would ensure the availability of bonds, the transition to T+1 will depend on the effective management of same-day positions. In Europe, the lack of sufficient overnight liquidity limits institutions' willingness to take risks for same-day refinancing, with institutions relying mainly on T+1, T+2 or longer funding.
- With regard to the transition to T+1 for government bonds, it is therefore essential to consider the impact of non-bank financial institutions (NBFIs), including UCITS, as liquidity providers, and their ability to transition to T+1 for their refinancing operations. The current debate on the regulation of NBFIs in the EU could pave the way for measures to promote the development of this industry, in particular by encouraging money market funds to adopt overnight refinancing practices.
- As for **corporate bonds**, the liquidity of this market is fragile[3], causing high fail rates even since the implementation of CSDR[4].
- Securities that need to be borrowed to settle the cash transactions may be available with institutional investors (pension funds, insurance companies and fund management companies) and some large companies. However, these market participants do not have the operational processes in place to lend their securities within 24 hours, so that hedging short positions in T+0 is currently difficult to achieve.

[3] This point is already amply documented. For example: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD700.pdf
[4] According to ESMA data (*Report on Trends, Risks and Vulnerabilities, No. 2, 2023, p. 25),* the settlement fail rate of corporate bonds even trended higher between mid-2021 and mid-2023 at EU level and, according to Euroclear France data, it was higher between January 2023 and April 2024 than that observed for other asset classes, with the exception of ETFs.

For both types of bonds, another important feature of the market for transactions other than standard Repos (ie financing transactions that may be concluded over a longer period than one day) is the possibility for the lender to recall the securities lent to the market maker, exposing the latter to the risk of having to source the bonds from another lender to be able to deliver them to its client to whom he sold them in the first place[5]. The deadline for returning the securities is set in the loan agreement concluded between the parties, currently 24 hours. The market maker must therefore find similar securities from another lender within a constrained time interval, which will be even more so in a T+1 environment.

The transition to T+1 will therefore require a significant mobilisation of the institutional lenders who will have to balance the cost of investment in the necessary adaptations (processing is currently mainly manual for them), the operational difficulties associated with standard settlement at T+0 (operational risk) and the income they derive from this activity, which may be minimal in relation to their total revenues (risk of increased costs of credit and settlement penalties).

This creates a risk of eviction of securities lenders and therefore constitutes a danger to the liquidity of the bond market that relies on these contributors.

It is indeed **important to consider lenders' sensitivity to changes in market infrastructure**. For example, recent regulatory developments in Thailand, requiring lenders to recall lent securities before they are eligible for sale, have led some lenders to halt lending in Thai securities. This situation highlights the potential for lenders to exit markets when regulatory or operational shifts affect costs or processes, particularly for "hard-to-borrow" and special stocks where securities lending is crucial for maintaining market liquidity.

For both corporate and government bonds markets, there is therefore a need for structural change to allow the liquidity of the Repo market to accommodate for the cash transactions settling at T+1. The entire ecosystem of market participants must adapt: market makers, investors, CSDs, and even issuers.

The increase in fail rate that the move to T+1 would cause otherwise, with CSDR penalties applying, would trigger a decrease in the liquidity of the bonds market with wider bid-offer spreads or even unavailability of some categories of bonds.

Without major structural changes, a settlement cycle at T+1 carries the risk of deteriorating the liquidity of the market as a result of:

- the withdrawal of certain securities lenders, making some categories of bonds unavailable,
- market makers offering smaller bid sizes to limit the risk of not finding the securities or widening the spreads to incorporate the cost of potential fails (inc. CSDR penalties if not suspended).

[5] Additionally, while focusing here on bonds, it is worth noting that the issues identified in the recall process are not exclusive to bonds and may also impact equities. We propose addressing these equity-specific concerns in more detail at a later stage.

B. ETFs – LIQUIDITY, TIME-ZONES AND CUSTODY

When it comes to ETFs, it could be argued that ETFs are not affected by a move to T+1, as they are not subject to the maximum settlement date set out in Article 5 of CSDR ("*no later than on the second business day after the trading takes place*"). While formally true, this argument is not valid in practice because:

- ETF shares are a specific asset, but they also represent the liability of a fund investing in shares, bonds, etc. If the settlement cycle of these shares and bonds moves to T+1, then the Asset and Liability Management constraints of the fund will require a shift in the settlement cycle of the ETF share to T+1, even though it is not required by regulation,
- ETF shares are subject to Article 7 of CSDR: late settlement in ETF shares triggers the payment of penalties, with similar consequences for market participants as for asset classes that are subject to Article 5 of CSDR.

This being stated, several features of the **ETF market** create **specific difficulties in the context of a transition to T+1**.

First, similar to the bond market, **the ETF market largely relies on the intervention of market makers**. While retail transactions are executed on exchange, large orders are executed on RFQ platforms or on Single Dealer Platforms with market makers.

The market making segment for ETFs is specific. Liquidity Providers (LPs) face clients and can unwind their positions with Authorised Participants (APs). In addition to facing clients and LPs, APs can ask the issuer to create new shares of the ETF or to redeem existing shares.

As with bonds, securities lending should help to facilitate the settlement of "cash" transactions, but, in contrast to the US, where 20% of ETF shares are lent and borrowed at any one time[6], **the SFT market for ETF shares in the EU is virtually inexistant**. This seems to be mostly due to the underdevelopment of the hedge fund industry in the EU, which appears to be the main source of liquidity for ETF share lending across the Atlantic.

Second, many ETFs invest at least partly in assets that are traded in other time zones. This makes the **creation / redemption process all the more complex**, as the request to create or redeem shares of the ETF is received by the asset manager while the reference price of the underlying asset is still unknown, and while the asset may not be actively traded in its time zone. Such situations require time to be managed, time that will precisely be further reduced by the move to T+1.

Third, and last but not least, **many ETFs are multi-listed and multi-deposited**, i.e. their shares are recorded on the books of several CSDs, under several ISINs. While clients prefer to trade in the share of their local CSD, the asset manager deals with a single fund, and meets creation / redemption requests through a single CSD. This means that APs have to manage their position in a given ETF across multiple CSDs, and perform multiple rebalances between CSDs, processes that are particularly burdensome and time-consuming.

[6] See ESMA's presentation at the open hearing organised in July 2024, slide 5.

Taken together, these factors make ETFs the asset class with the **highest fail rate in the EU**. The transition to T+1 will make things more complex at an operational level and, unless the above barriers are effectively tackled, could cause serious disruption to the EU ETF market.

III. SUSPENDING AND ADAPTING THE CSDR PENALTY REGIME

The implementation of T+1 should also **be assessed in the light of the current and forthcoming revisions to CSDR's rules on settlement discipline** (penalty and buy-in). The shortening of settlement cycle is likely to cause, at least in the short term, a higher volume of settlement issues, which will be met by **higher penalties who will particularly affect bonds and ETFs.**

Therefore, **the CSDR penalty regime should be suspended for bonds and ETFs once T+1 is implemented.** This suspension should last for at least three months and could be extended depending on the actual situation of settlement fails in the EU. ESMA should adopt a consistent approach to the reform of the CSDR penalty regime that would consider the transition to T+1.

If co-legislators are not willing to suspend a priori the CSDR penalty regime, at the very least they should ensure, together with ESMA, (i) to operate **a close follow-up of the evolution of fail ratios** for each relevant asset class and (ii) to **have tools ready for immediate suspension of the CSDR penalty regime**, either on a transversal basis or for selected asset classes, if fail ratios increase to such an extent that related penalties threaten to disrupt the market.

Moreover, irrespective of any suspension, consideration should be given to introducing a more granular regime that takes into account the specificities of some asset classes. **Especially for ETFs and bonds, the starting date for the calculation or payment of penalties could be set at T+2.**

Lastly, it is worth noting that there is no penalty regime comparable to CSDR in the UK. It is imperative to assess the risk of the UK attracting an increasing share of the bond market away from the EU and expanding the liquidity of their markets, making it impossible for the EU markets to compete on price. It should also be recalled that there is no penalty rules[7] on settlement fails in the US.

[7] Although the US do have market practice guidelines for fails of Treasuries under the Treasury Market Practice Group: TMPG-Fails-Charge-FAQ-04-23-2018.pdf (newyorkfed.org)