ASSOCIATION
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DES MARCHÉS
FINANCIERS

FINANCIAL MARKET PROFESSIONALS

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ESMA's CALL FOR EVIDENCE ON SHORTENING THE SETTLEMENT CYCLE
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AMAFI's answer

AMAFI is the trade association representing financial markets' participants of the sell-side industry located in France. It has a wide and diverse membership of more than 170 global and local institutions notably investment firms, credit institutions, broker-dealers, exchanges and private banks. They operate in all market segments, such as equities, bonds and derivatives including commodities derivatives. AMAFI represents and supports its members at national, European and international levels, from the drafting of the legislation to its implementation. Through our work, we seek to promote a regulatory framework that enables the development of sound, efficient and competitive capital markets for the benefit of investors, businesses and the economy in general.

AMAFI would like to thank ESMA for this consultation on the shortening of the settlement cycle to T+1/T.0, as this topic is very important to its members.

The answers to the questions were prepared in cooperation with other French associations, notably *France Post Marché* (FPM) and *Association Française de Gestion* (AFG).

1. General comments

Before responding to the specific questions, AMAFI would like to stress the following points:

- We consider that the transition to T.0 would imply a technological change (DLT) that we believe is unattainable in the medium or even long term. For this reason, we have not studied this scenario.

- We strongly believe that in a purely European context, there is no advantage in moving to T+1. However, we must consider the international environment and the attractiveness of European markets. Yet, in our opinion, Europe's attractiveness does not depend on settlement/delivery timeframe. Indeed, there is no evidence that an issuer relies solely on settlement/delivery timeframe to raise capital in a given jurisdiction. Moreover, it should be assessed whether maintaining a T+2 settlement cycle could present some advantages for the EU market in terms of attractiveness (notably for Asian investors due to time zone difference).

- The move to T+1 in Europe will require a radical change from EU market participants including market infrastructures (trading venues, CCPs, settlement and payment systems). For these reasons, the move from T+2 to T+1 cannot be compared to the previous move from T+3 to T+2.

- This radical change will demand considerable resources while these resources could probably be better used for instance to achieve the UMC (investing in financial education, in financing the European economy or in addressing environmental issues…).

- Furthermore, it should be stressed that the European market has many specificities compared to other markets. Europe has 18 CCPS, 31 CSDs and 14 different currencies, while for instance the US have only one CCP, one CSD and one currency, like in Canada, the UK and some Asian countries. As a result, the operational difficulties and costs involved in switching to T+1 in Europe are much higher than in jurisdictions where the markets are much more integrated.

- We foresee that the shortening of the settlement cycle is not compatible with the trend to enlarge trading hours, notably for the benefit of retail clients in the EU. Moreover, moving to T+1 could cause EU trading venues to close their markets earlier than today, at the expense of the overlap between US and EU markets.

- We anticipate that the transition to T+1 in other jurisdictions would have consequences for European stakeholders (investment firms and management companies) that should not be underestimated, as stated in our answers to the consultation. It will be easier to assess the costs and benefits of a move to T+1 in Europe once the other markets (particularly the US market) have moved to T+1.

2. AMAFI's answers to ESMA's questions

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 which could result from compressing the settlement cycle to T+1 and to T+0. Please:

(i) provide as much detail as possible on what issues would emerge in both cases and how they could be addressed, focusing on critical processes (matching, allocation, affirmation and confirmation) and interdependencies. Where relevant please explain if these are general or asset class/instrument/ trade specific.

(ii) identify processes, operations, types of transaction or settlement instructions (e.g. DvP , FoP) or financial instrument class that would be severely impacted or no longer feasible in a T+1 and in a T+0 environment.

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

As stated in our general comments we have not analyzed the T.0 scenario.

In a nutshell, we anticipate that the following issues would emerge from compressing the settlement cycle to T+1:

1. Settlement processes from investors to brokers/clearers and to infrastructures.
2. Specific processes such as management of corporate actions, impact on funds and ETF's.
3. Operational impacts (staff management, business continuity…)

For all these specific impacts please refer to FPM response and specifically to the diagrams attached to their response which were prepared in relationship with AMAFI.

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?

- The wholesale FX market is already able to and do settle on T+1, however there is particular concern for cross-border transactions where participants are in different time zones (e.g. Asia)
- FX orders usually follow the securities trade confirmation – thus the FX component may effectively have to settle on T0 relative to the FX order.
- Also, there will be a strong need for prefunding, so the prefunding practices will need to be revised.

Q3. What 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?

The complexity of the settlement chain and the diversity of all the actors make it difficult to estimate the rate of STP transactions. However, the use of STP process does not guarantee that human intervention will not be needed. Even if this process helps a lot to improve and accelerate transactions, it cannot be fully sufficient by itself. Therefore, we consider that STP would not serve as a substantial indicator of the settlement efficiency's ability to handle a transition to T+1.

Q4. Do you expect the shortening of the securities settlement cycle to have any other impacts on the functioning of markets (trading, liquidity formation) and on the access of retail investors to financial markets? If you identify any negative impact with a legislative or regulatory root cause, please identify the piece of legislation affected (MiFID II, MiFIR, Short Selling Regulation, etc.) and elaborate on possible avenues to address it.

On this question, AMAFI would like to highlight a **negative impact on liquidity**. On several products, and notably corporate bonds, liquidity providers cannot trade solely on their inventories. They often offer prices on bonds that they do not own, but whose borrowing cost they have a view on (that they include in their offer). If, and once, the transaction is done, they then need to secure a borrowing transaction quickly enough to ensure the settlement of the transaction with their own client. If such borrowing transaction is concluded the next day, then it will have to settle T+1. If it is concluded on T+2, it will have to be immediately settled.

Reducing the settlement cycle would obviously limit the time available for liquidity providers to source liquidity, which would have a variety of effects: it would impact the quality of settlement, but also the availability and cost of liquidity offered to investors.

Costs and benefits of shorter securities settlement cycle

Q5. What costs would you have to incur in order to implement the technological and operational changes required to work in a T+1 environment? And in a T+0 environment? Please differentiate between one-off costs and on-going costs, comparing the on-going 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.

At this stage, it is very difficult to assess with precision all the costs involved. On a more general level we can oversee:

On direct costs:
- Technological costs to be able to process the rise of volumes (automatization of some processes, software acquisitions...)
- Operational costs due to the transformation of the current model (this includes human costs because there will be a need to increase the workforce and be faster on operational duties)

On indirect costs:
- Infrastructure transformation
- Securities lending and borrowing
- Liquidity
- Foreign currency
- Settlement risk (on short term)
- CSDR penalties (on short/middle term)

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

The exact estimation of the increase of fails and cash penalties is not possible at this point. However, we believe that fails and cash penalties will be at the highest level at the beginning of the T+1 implementation. We anticipate that this level will decrease over time, but we are not sure that it will come back to the current situation. T+1 should not be implemented at the expense of settlement efficiency.

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.

See Q.6 above.

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.

We can anticipate several types of costs after a transition to T+1 settlement cycle:
- Important costs resulting from the need to change EU market infrastructure (specially on T2S platform to adapt to new hours and cut offs)
- Extension of the ECB payments cut-off
- Important internal investments for market participants at the expense on other ongoing projects.
- Increase of securities costs due to lower liquidity.

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?

From our perspective, the benefits mentioned are very marginal compared to the costs. Indeed, the benefits mentioned by ESMA are purely theoretical.

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 noncleared transactions subject to margin requirements).

Collateral requirements on cash transactions reflect the magnitude of settlement risk, i.e. the risk of a credit event occurring during the settlement cycle.

The diffusion of such risk depends on time. Most models of risk diffusion consider that time dependence is correctly modelled by the square root of time.

Moving for T+2 to T+1 would mean, in the best possible case, a reduction by sqrt(2) of 1, which is a reduction by less than 30% of the collateral requirements for the settlement of cash transactions.

This could seem to be significant, but it should be reminded that, at the scale of the financial industry, collateral requirements linked to cash transactions are a negligeable fraction of the requirements linked to derivative transactions. Typically, the exclusion of Post Trade Risk Reduction services from clearing obligation offers a for more effective lever to reduce collateral requirements.

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.

At this stage AMAFI does not see any significant savings. In a context where market processes are highly automatised or STPed, the marginal benefit of a bigger automatization is totally accessory compared to all the costs consecutive to a move to T+1.

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

See answer to Q4.

Q13: What would be the benefits for retail clients?

We do not see any benefits for retail clients who are not concerned by settlement cycles. *A contrario,* this could have a reverse effect on retail clients since the high costs for investment firms to implement T+1 could have an impact on explicit costs of transactions.

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

As mentioned earlier we expect much more costs than benefits from a move to T+1. We also think that it is too early to make a precise analysis on costs and benefits because we lack information on how exactly the market will be structured and all the future impacts of the new settlement cycle are not anticipable yet.

- **How and when to move to a shorter securities settlement cycle**

Q15: Please describe the main steps that you would envisage to achieve a 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.

See our response to Q.16

Q16: If the EU institutions were 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?

If a move to T+1 were decided, we would advocate for a close cooperation between EU policy bodies and market participants, including infrastructures. It is not possible to anticipate the timeframe of such a transition but, as stated above, it will be very complex. Therefore, it is not a question we are able to answer for now.

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 view a more adequate scope?

AMAFI considers that T+1 implementation should be aligned with CSDR's scope (paragraph 2 of article 5). In other words, each transaction executed on an EU trading venue and settling in a CSDR CSD when its underlying financial instrument is a transferable security (unlike what is written in point 44, the 3 other asset classes are out of scope) should be required to settle on T+1.

Q18: Is it feasible to have different settlement cycles across different instruments? Yes/No, please elaborate.

This question seems irrelevant. In fact, we already have different settlement cycles across different instruments.

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? Would it be feasible/advisable to have different migration times for different products/markets/assets? If yes, please elaborate.

See our responses to Q.17 and 18.

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?

No. The rules for transactions currently excluded by art. 5 of CSDR should not be modified even if the settlement cycle is shortened.

- **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

As stated above, we anticipate that the transition to T+1 in other jurisdictions will have an impact on EU market participants remaining on a T+2 cycle. That said, it is not obvious that those impacts would justify moving to a T+1 cycle in the EU. Anyway, we will concretely be able to assess the consequences of T+1 implementation in the US in Q.2 2024.

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.

We do not have an opinion on this question.

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

From a theoretical point of view, AMAFI considers that a global harmonization could be welcome. But, as a first step, we would suggest harmonizing the European market (operationally with CSDs, currencies, CCPs and then on a regulatory standpoint).

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

No. We fully support the Capital Markets Union with the objective of developing the European economy and securing the retirement of European citizens. AMAFI considers that the reduction of the settlement cycle is not a criterion on which an issuer would rely to raise capital to develop its activities in Europe.

As indicated in the answers to the previous questions, shortening the settlement cycle will require considerable resources both from the legislator and, above all, from financial market participants (investment firms, market infrastructures and even T2S systems) for very little expected benefit.

These resources could be put to better use to achieve the CMU's objectives in areas such as financial education, financing the economy and environmental issues.

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.

We consider that the formulation of the question is irrelevant. The decision of transitioning to T+1 in Europe should not be based on the consequences of such decision in other jurisdictions but mainly rely on European markets competitivity. This decision should be based on actual cost/benefits analysis.

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

Of course, this scenario is not optimal, but we do not anticipate that it would be so detrimental that Europe would have to rush to T+1. It must also be reminded that discrepancy between EU and US on settlement date has occurred in the past without major inconveniencies. EU adopted a T+2 settlement in 2014 cycle while the US market continued to stay on a T+3 settlement cycle until 2017.

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.

Please refer to our general comments and responses to ESMA’s questions above.