ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

AMAFI / 24-57
9 September 2024

# TOWARDS A SUCCESSFUL TRANSITION TO T+1

## AMAFI'S HIGH-LEVEL POSITION

---

*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.*

In a tense and uncertain geopolitical context, the European Union is lagging behind the United States and China in economic terms. While its construction is directly threatened by the rise of Eurosceptic parties, greater integration appears necessary to develop the Union's strategic autonomy in key sectors. In particular, it is critical to strengthen the competitiveness and attractiveness of EU's capital markets to make them deeper and more liquid, so they are in a capacity to finance the Union's economy.

In preparation of the future EU legislative agenda, the European Commission is contemplating several reforms to develop EU capital markets and make them more competitive. With regards to the post-trading landscape, it has initiated a workstream to prepare the transition, similarly to what the UK has undertaken. At the international level, Canada, India and the US have successfully shortened their settlement cycle.

With regards to the move to T+1 in the Union, **we firmly believe that it is only through the collaborative identification of prerequisites and the establishment of an appropriate timeline to implement them, that a feasible transition date can be determined.**

With the objective to contribute to ongoing discussions taking place at EU level, this note aims to emphasize that **(i) the US transition model cannot be transposed as such given the specificities of the EU market** and **(ii) the elements we consider at this stage (further work still ongoing) as critical to enable a successful transition to T+1 in the Union.**

# I. The success of the transition in the US should not blind EU authorities on the incomparable complexity of a similar move in the Union

While it would be tempting to transpose **the US three-year transition model**[1], which so far has revealed successful, and to adopt the same calendar in the EU, it would in fact **not be realistic given the structural differences between the two jurisdictions. In addition to this, it should be recalled that the implementation of T2S took 4 to 5 years while the transition to T+1 will be more impactful.**

Regarding the **market infrastructures, in the US there is only one CCP and one CSD** while in the Union it is the opposite with 16 CCPs and 29 CSDs. The diversity and fragmentation of the European market is also reflected in the **number of competent authorities**, **different tax regimes** and **14 different currencies** used.

In this respect, **the target date of H2 2027 for the EU to transition is overly ambitious.**

It is also important to bear in mind that even though **the misalignment with the US has impacts on the functioning of markets**, (i) this situation is not without precedent, as the US remained at T+3 for around 3 years when the EU moved to T+2 in 2014, and (ii) prior to the transition to T+1, EU wide solutions can be found to mitigate these impacts.

In light of the specificities of the EU market, a **realistic transition date to T+1** can only be defined once **(i) the prerequisites for a smooth and orderly transition are identified** and **(ii) the timeframe for their implementation is agreed upon. This is all the more important as the transition to T+1 could result in long-term and persistent increase in settlement fails, impacting the credibility and competitiveness of the EU. Additionally, it is critical to agree on a realistic date as otherwise the Union would face delays as well as market uncertainty and disruption.**

# II. Critical prerequisites for a successful transition to T+1

## A. Ensuring that the settlement processes and tools are adapted to a T+1 settlement cycle

**Settling transactions in T+1 is already possible in the EU, but the T+1 cycle is currently the exception**. Making T+1 the standard settlement cycle will require to implement many changes in the tools and processes operated by the CSDs, but also in the processes used by the market participants upstream of the CSD.

The settlement of a transaction requires that the two counterparties to this transaction, and intermediaries acting on their behalf **(i) input their settlement instructions in a timely, accurate and**

[1] The US Securities and Exchange Commission signaled its intention to shorten the settlement cycle to T+1 in early 2021.

**complete manner**, and **(ii) have the necessary resources (i.e. securities and cash) available for settlement in due time and in the correct account**.

Moving to T+1 means **reducing the time available to complete these actions**.

A smooth transition to T+1 hence requires that each participant to the value chain ensures that its own process is consistent with the move to T+1, **taking into account the constraints imposed by the other participants to the processes**. Engineering that move requires an holistic approach to determine what changes may be needed notably to:

- venues trading hours,
- market participants processes and tools for pre-matching, allocation and confirmation,
- clearing processes,
- CSDs input cut-off time, timeframe for night-time settlement (NTS) and settlement cut-offs.

## B. Adopting an asset class specific approach

We consider that given their specificities, a **specific approach should be considered depending on the asset class.**

The bond market **relies on the intervention of market makers who are the only ones able to satisfy investors' need for immediacy**. To answer their clients' needs, market makers do not only deal in securities they hold in their inventory. If they did, market liquidity would be much lower. Thus, when a client transaction places a market maker in a short position, it seeks to borrow the relevant securities to ensure the successful settlement of the transaction. These borrowing transactions are therefore carried out in a shorter time than the "cash" transactions to which they relate, i.e. currently at T+1 or T+0, although liquidity is almost non-existent at T+0.This situation explains why the settlement fails remain more frequent for bonds, even after the implementation of CSDR.

**Shortening the settlement cycle would thus have the direct effect of requiring the settlement of borrowing transactions at T+0**, which is highly problematic given that the European overnight repo market remains underdeveloped, contrary to the US**. The most likely outcome is hence a sharp increase in fail rates and, if penalties apply, a decrease in the liquidity of the bonds market with wider bid-offer spreads or even unavailability of some categories of bonds.**

Similarly, **the ETF market relies on the intervention of market makers, at least for transactions of significant size**: Liquidity Providers (LPs) face clients hedging themselves with Authorised Participants (APs) who can ask the issuer to create new shares of the ETF or to redeem existing shares. It should be noted that even though ETFs are not required to comply with the maximum settlement cycle set out in Article 5 of CSDR, if the assets they hold (shares and bonds) move to T+1, the ETF shares will most likely also move to T+1. It is also worth noting that ETF shares are subject to Article 7 of CSDR: late settlement in ETF shares triggers the payment of penalties, with **ETFs being today the asset class with the highest fail rate in the EU.**

In light of the issues at stake, we are **calling EU authorities to carefully assess the impact of a transition at least for these market segments**, if only to determine specific adaptation measures to the CSDR penalty regime (see below). We would be pleased to share our analysis in the coming weeks.

## C. Suspending and adapting the CSDR penalty regime

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

Therefore, **we ask for the suspension of the CSDR penalty regime once the transition period to T+1 is implemented.** The suspension period should **at least be set up for three months and could be extended** given the actual situation of settlement fails in the EU. **ESMA should adopt a coherent approach for the reform of the CSDR penalty regime that would take into account the transition to T+1.**

Moreover, independently of the suspension period, it should be envisaged to put in place a more granular regime taking into account the specificities of some asset classes. **Especially for ETFs and corporate bonds for which the starting date of calculation of penalties could be set up at T+2.**

Lastly, it is worth noting that **there is no penalty regime in the UK**. It is **imperative to assess the possibility of measures taken by the UK that would attract a growing share of bond transactions away from the EU**. It should also be recalled that there is no penalty rules[2] on settlement fails in the US.

## D. Coordinating with UK and Switzerland authorities

**Coordination between EU, UK and Switzerland authorities with regard to the transition to T+1 is highly desirable. Ideally, it should result in simultaneous moves**, to avoid adding new sources of misalignment between European jurisdictions.

Still, from an EU point of view, coordination **should not mean aligning timeframes at all costs.** Similarly to the US, one should highlight the UK and Switzerland have a much simpler transition to manage than the EU because of the unicity and integration of their settlement infrastructures.

An important point of coordination will be **to ensure that, if transition dates are not aligned, the extra-territorial effects of the UK transition are as limited as possible**. The EU authorities' objective should be to ensure that EU securities (i.e. those registered with an EU CSDs or ICSDs) **could not have their settlement cycle altered by a unilateral decision of the UK.**

[2] 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)

This means that EU authorities should ensure that **if the UK transitions before the EU, the UK settlement cycle only applies to securities recorded in the books of CREST** and not to transactions in securities registered with EU CSDs or iCSDs (typically, Eurobonds), even when such transactions are executed on UK trading venues. If such principle were to be breached, **it would create a double standard for the settlement of the relevant instruments and would impact the EU settlement processes.**