

T+1 in the EU, a major challenge to be approached in two steps

Executive summary

As a move to T+1 appears to be inevitable in the EU according to the European Commission, a transition of this magnitude implies many challenges to address and should occur in timely and efficient manner. Through this paper, the AMF and the Banque de France would like to contribute to the debate on “how” and “when” a shortening of the cycle should occur in the EU.

In this respect, we strongly believe that the best way to implement this reform implies:

- **First, a strong coordination with other large European jurisdictions. Given the interdependencies between these markets and the ambitious timeline put forward in the UK Accelerated Settlement Taskforce Report, such a coordination should start as soon as possible;**
- **Second, given all the challenges at stake, considering a two-step approach:**
 - **As first step and prerequisite, all trades should be confirmed/allocated as soon as practicable and no later than on trade date. In the same vein, all necessary operational and technical improvements must be achieved by the industry (e.g. standardization for the exchange of data, automation of manual processes, etc.); and**
 - **As second step, settlement cycle could be reduced to T+1 provided that the level of transactions confirmed/allocated on trade date is deemed as sufficient. The timing of this step should of course also take into consideration the necessary coordination with the UK and lessons learned from the US/Canada move to T+1.**

As of today, the Commission should play a key role to launch working groups on all relevant topics and with all stakeholders in order to achieve step 1 as soon as practicable.

Finally, discussions around the design of the future T+1 framework should not only focus on the scope of the rules but also explore all possible means or tools to encourage T+1 (e.g. regulatory and economic incentives).

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A- The global context of a move to T+1.

The decision by the US to move to T+1 has created a misalignment between the European settlement cycle and the US settlement cycle that entails a number of technical difficulties and costs for global market participants. Many jurisdictions around the world are also considering such a transition or have already implemented a reduced settlement cycle. In this context, there is a momentum in all European jurisdictions to move towards T+1. The UK has already publicly announced that it would move to T+1, though with limited enthusiasm through the « Accelerated Settlement Cycle Taskforce » report published on March 28th.

In terms of migration timeline, that report recommends a two-step approach with two deadlines: first, important operational changes that are necessary to allow for a compression of the settlement cycle should be implemented by 2025 and second, the effective switch to T+1 should occur before the end of 2027.

However, the report states very clearly that the UK may adjust its own process in order to move simultaneously with the EU. This should be regarded as a key objective since discrepancy in the settlement cycle between the EU and the UK would be much more problematic and disruptive than with the US.

Finally, on 25 January 2024 the European Commission stated that the Commission now considers that what *“we need to discuss is not if Europe will make the move to T+1 settlement. Instead, the key issue is when and how we move”*¹.

In this context, the AMF and the Banque de France would like to contribute, through this paper, to the debate on “how and when” a transition to T+1 should occur with a proposal of a way forward, if it is decided by the legislator.

B- An operationally complex transition that calls for a careful calibration of the timeline.

The functioning of the markets and in particular of the post-market chain is a very technical topic and, as regularly pointed out by market participants, the EU post-trading landscape is very diverse and fragmented, notably when compared with the US or the UK.

A reduction of the settlement cycle in the EU entails challenges that should be carefully assessed, including from EU competitiveness perspective. ESMA’s report, which should be published by the end of 2024 is expected to provide for such assessment.

A transition to T+1 could bring direct benefits, namely the reduction of counterparty and market risk, and other benefits in the long term such as global automation of post-trade process or reduction of liquidity needs associated with margin call even though the magnitude of these benefits remains uncertain².

However, a transition of this magnitude implies many challenges to address:

¹ Statement made on 25 January 2024 at the Commission’s roundtable on shortening the settlement cycle in the EU.

² Indeed the impact is less clear in the EU than in the US. If the US CCPs have estimated that the volatility component of the margin calls with respect to cash equities will be reduced by 41%, there are not yet clear estimates in the EU (nor in the UK).

- First, a move to T+1, if not properly prepared, could significantly impact the number of settlement fails, at least temporarily³;
- Second, a move to T+1 could imply some impacts on the way securities lending operations function as of today and involve additional constraints for those engaging in such operations;
- Third, a move to T+1 will impact all layers and we still need to figure out to which extent that will have an impact on market liquidity;
- Finally, we also need to take into consideration the impact that the transition to T+1 may have on the current ecosystem and in particular on small firms which may not be able to meet the process and costs linked to such move.

Furthermore, time zone constraints and concerns about the impact on investment by foreign investors into EU should also be taken into account. Having in mind all these considerations, the EU industry will need sufficient time to prepare for such significant changes and to ensure maintaining an appropriate level of settlement efficiency in the EU. All of these challenges must be analysed with regard to the specificities of each category of financial instruments.

The timing of the move should therefore be tailored in a way that makes it possible for the EU to move with other large European jurisdictions (e.g. the UK and Switzerland, subject to a political agreement with these jurisdictions) while granting sufficient time to the European industry to get prepared.

C- A two-phased approach: the most pragmatic way forward.

Improving settlement efficiency should be a priority and a mandatory condition prior to any reduction of the settlement cycle. Efforts must first be allocated to this objective.

In view of improving settlement efficiency in the UE and to pave the way towards a potential move to T+1, we believe that a **two-step approach** should be considered.

As a first step and prerequisite, all trades should be confirmed/allocated as soon as practicable and no later than on trade date. In the same vein, improvements must be achieved by the industry in the following fields:

- standardisation and common market practices in the EU (cut-off of market infrastructures, *etc.*);
- settlement of cross border transactions;
- settlement of ETF shares.

Finally, it will also be necessary to ensure that the T2S operator has sufficient time to prepare for the settlement of an increased volume of trades during the real time settlement period, and for the postponing of the night batch settlement.

In order to implement all the necessary changes as soon as practicable, **the Commission should play a key role to launch working groups with all stakeholders and on all relevant topics, including the impact on the European financial industry competitiveness, the liquidity and the human resources, in order to achieve step 1 as soon as practicable.**

As a second step, settlement cycle could be reduced to T+1 provided that the level of transactions confirmed/allocated on trade date is deemed as sufficient. In this case, the scope of the T+1 rules should be carefully designed in order to ensure that it will not reduce the appetite of foreign investors for EU products and taking into account time zone consideration. This two-step approach will also

³ For instance, the industry and market infrastructures, including T2S, have experienced difficulties to implement the cash penalties regime under CSDR, although its entry into application has been delayed for several years.

allow for a sufficient observation period in order to draw relevant conclusions from the US/Canada move to T+1. Even if these markets are not fully comparable with the EU markets, it will be interesting to observe the impact.

There are many ways to implement a shorter settlement cycle and several paths could be explored. We could go beyond setting up a mandatory cap and find incentive measures or tools (e.g. via the best execution or additional settlement costs as it is the case in the US).

Finally, from a practical standpoint, the migration plan could also consider transitional measures, in particular with respect to CSDR cash penalties mechanism.

While progressing on the preparation of an EU move to T+1, EU institutions should also consider cooperating more closely with the UK authorities and the UK Accelerated Settlement Task Force, in view to ensure a coordination of the UK and EU moves to T+1. Given the interdependencies between these two markets and the ambitious timeline put forward in the UK report, such a coordination should start as soon as possible.

D- Developing European solutions with the industry for a tailored transition in the EU.

In order to allow for a compression of the settlement cycle, all the steps between the execution of trades and the settlement should be enhanced and automated where possible. This compression will in particular require trades to be confirmed and allocated no later than on trade date. Automation in that field will imply use of platform and tools easing the exchange of information between all the stakeholders along the trade/settlement chain.

However, if everyone agrees that we should work on the automation / speed up of the confirmation and allocation process, we should be conscious that, as of today, there is no real EU service offer in this field.

The EU industry should work together and build tools / platform that will enhance settlement efficiency and allow for a reduction of the settlement cycle. T2S and new technologies could also play a role in this respect.

This aspect should be taken into account where assessing “when” T+1 could occur in the EU.