ASSOCIATION FRANÇAISE DES MARCHÉS FINANCIERS

T+1

WHEN AND HOW SHOULD THE EU MOVE TO SHORTER SETLLEMENT

AMAFI'S OBSERVATIONS

In the context of the EU's foreseen move to T+1 settlement for securities, DG FISMA is in the process of consulting Member States on when and how this transition should take place. It has prepared a paper with set of questions to be discussed at the meeting of Member States' Experts on 5 September. The feedback received should contribute to the Commission's reflections.

In view of this meeting, AMAFI would like to share the observations set out below.

Q1. Do Member States agree that the EU should move to a shorter settlement cycle to alleviate these impacts?

As noted by DG FISMA, the move to T+1 in the US, while the EU settlement cycle so far remains at T+2, has an impact on European market participants, first and foremost fund managers, but not only. The transition to T+1 in the Union would indeed reduce the effects of the difference with the US and, more generally, seems inevitable.

However, the facts at hand must temper the sense of urgency for such a move.

The move to T+1 represents an incomparable level of complexity in the EU versus the US, for e.g.:

- The EU post-trade environment is much more fragmented than the US (14 currencies vs 1, 16 CCPs vs 1, 29 CSDs vs 1),
- In the US, most large broker dealers engage directly with the CSDs, whereas in the EU, engagement is indirect, via a series of global and sub-custodians,
- The US settlement system operates on a continuous net settlement ("CNS") basis, a function that does not exist in EU, which implies a slower process with batches at set times.

In this respect, the paper's suggestion that the EU could be ready by H2 2027 is rather worrying. **The date of transition should be based on the determination of the time needed to implement the projects necessary to adapt that settlement processes to a T+1 cycle**. As of today, the identification of such projects has not properly started.

It should also be noted that:

- The US, with a much simpler infrastructure, have given themselves 3 years (which the paper implicitly acknowledges),
- As mentioned in the paper, Australia is considering a transition, and the stock exchange has launched a working group and issued a consultation in April. What the paper does not mention is that the feedback obtained estimates that the transition itself will take 24 to 36 months, not including the necessary replacement of the settlement system (CHESS). The feedback "advises against implementing T+1 simultaneously with replacing CHESS due to the substantial industry effort required", implying a T+1 move around 2030,
- While the misalignment with the US indeed has impacts, it should be noted that (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 that (ii) prior to the transition to T+1, EU wide solutions can be found to mitigate these impacts (including for instance changes to UCITS rules on cash and borrowing limits) and avoid the market fragmentation that DG FISMA is highlighting in its paper. In any case, the challenges of moving to T+1 in the EU far outweigh the impacts of the misalignment with the US.

Q2. WOULD YOU SUPPORT A BIG BANG APPROACH FOR THE SECONDARY MARKET MOVE?

Even though no one has so far advocated a staggered approach that would differentiate the timing of the transition by asset class, it should be noted that:

- The US have, in practice, proceeded through a staggered approach since their Govies market moved to T+1 well before May 2024,
- Some EU market segments may merit ad hoc treatment, as they present specific issues (in terms of settlement, but also more generally in terms of functioning), which will be exacerbated by the transition to T+1 and cannot be solved only by the "generic" adaptation of settlement systems and processes. This is notably the case for bonds and ETFs. The best option would probably be to apply differentiated disciplinary measures, at least for a while, rather than set a later transition date.

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. This is due to 2 specific complexities:

- The fact that many ETFs are multi-listed and multi-deposited, i.e. with shares recorded on the books of several CSDs, under several ISINs. APs need to manage their position in a given ETF across multiple CSDs, and perform multiple realignments between CSDs, processes that are particularly burdensome and time-consuming today,
- The lack of a lending and borrowing market for ETF shares in Europe. Such a market would facilitate settlement. In contrast, in the US, this market is quite active and almost 20% of ETF shares are lent (see slide 5 in the ESMA presentation at the open hearing).

Finally, one should note that some of the concerns with bond lending also exist with equities lending and will need to be further explored.

Q3. Should the settlement of primary market operations (issuance) be shortened as well?

As a preamble, this question makes sense only for the primary market of shares and bonds.

For UCITS, and especially for ETFs, (i) the settlement cycle is not mandated by CSDR Article 5, but (ii) the fact that the assets owned by the fund move to T+1 creates a strong incentive to move the settlement cycle of the shares of the fund accordingly, including for the primary market transactions (creation / redemption of shares).

Q4. Given the interconnectedness of the EU, the UK and Switzerland, do you agree that a potential EU move to T+1 should be coordinated with the UK and Switzerland's moves?

Indeed, coordination between the European jurisdictions will be highly desirable. Still, it must be made clear that, from the EU point of view, coordination should not mean aligning timeframes at all costs.

Two factors should be highlighted:

- The UK and Switzerland will have to manage a much simpler transition than the EU, because of the unicity and integration of their settlement infrastructure,
- UK market participants, and especially fund managers, are significantly more exposed to the EU settlement cycle than the other way round, simply because UK fund managers hold significantly more EU assets than EU fund managers hold UK assets. UK authorities therefore have a particular interest in alignment, so that EU authorities should be able to ensure that EU-specific issues are duly considered.

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. It will be important to ensure that the UK does not purport to apply its settlement cycle to securities settled in EU iCSDs, even if they relate to (i) securities issued by UK companies or (ii) transactions traded on UK platforms. The case of dual listed securities will also have to be considered, maybe scoping them out of the UK T+1 until the EU has moved.