EUROFI MAGAZINE: Post trading: Shortening settlement cycles: Is T+1 the way to go?

MONTSERRAT MARTÍNEZ PARERA, VICEPRESIDENTA DE LA CNMV

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Ten years ago, European markets transitioned to the current T+2 cycle from T+3, requiring all transactions executed on trading venues to be settled in two business days. It was a significant undertaking across EU securities markets. Since then, settlement efficiency has improved notably, particularly after the disciplinary measures introduced in 2022. However, the improvement has not been even across all jurisdictions and assets classes, and it still can be strengthened.

The recently adopted CSDR Refit is precisely envisaged to tackle certain issues related to settlement failures. This is important. Settlement efficiency plays a critical role in the execution of financial transactions, ensuring both certainty and timeliness, which keep counterparty credit risk under control. Indeed, reducing settlement fails to a minimum will enhance the functioning and competitiveness of the European capital markets. ESMA's recently published consultation paper aims precisely to contribute to this goal by enhancing settlement discipline measures.

However, there are two additional main trends to consider within the settlement business: the steps being taken by some jurisdictions to further shorten the window cycle towards T+1 and the potential of new technologies (distributed ledger technology (DLT) to revolutionize the settlement process.

Both trends point towards an acceleration of the settlement cycle, but I will focus on the former. Questions arise whether Europe should follow this path, and if it does, what benefits it would bring to the European markets. Answering these questions is not straightforward, and the implications need to be carefully weighed.

On the one hand, reducing the settlement cycle could reduce liquidity needs and counterparty exposure thereby reducing margin and collateral requirements. These associated savings in margins are usually presented as one of the main benefits.

Additionally, the upcoming shift to T+1 in the US, Canada and Mexico in May 2024 poses additional pressure on us to follow the same approach to avoid a potential gap in the perceived competitiveness of European markets. Other jurisdictions such as India have already made the move. And more importantly, current discussions held in the UK should be followed closely.

This context aside, the unique nature of the European Union infrastructure means important challenges remain to be considered. Multiple trading venues, central counterparties, and central securities depositories, together with several currencies, help create a complex ecosystem with additional frictions. Navigating this fragmentation requires a comprehensive understanding of diverse regulatory frameworks and market infrastructures, adding yet more complexity to the T+1 adoption process.

The impact on the resilience of settlement systems requires a thorough assessment. With less time available to settle trades operational risks may increase. If a shorter settlement cycle is implemented, settlement fails run the risk of increasing which would also lead to a cost increase due to cash penalties.

It should also be mentioned that embracing a shortened settlement cycle would require a high level of automatization and investment costs, with uneven effect on market participants. In this context, smaller players may find it difficult to adapt their systems to a shorter settlement cycle and would require sufficient time to prepare. It is also important to consider to what extent the financial implications of such investments could be passed on to retail clients.

ESMA has already initiated a call for evidence to obtain the perspectives of stakeholders on these matters that will help us to better understand and address any of the risks and challenges before taking the decision to move to T+1. In cooperation with the members of the ESCB, ESMA will prepare a report to guide European authorities on the potential shortening of the settlement cycle.

Many believe the question is not if, but when and how. In this rapidly evolving environment, European markets can not be caught napping. However, a careful consideration of associated risks and costs needs to be conducted, given that moving to a faster settlement process could also have a negative effect on our attractiveness. A successful transition would also require proper time to allow a smooth compression of the settlement timelines and, more importantly, a joint purpose and coordination of all stakeholders involved. Europe already has experienced a successful transition from T+3 to T+2 which was the result of planning, testing and coordination across the industry. We are now considering whether to tackle an even more challenging change and it should be done after careful analysis.