Harmonisation of Settlement cycles: Reasons why T+1 was not considered as a valid option.

<u>Objective</u>: The objective of this paper is to document the reasons why the Harmonisation of Settlement Cycles Working Group (HSC WG) decided not to consider T+1 as a valid option in its effort to harmonise settlement cycles across Europe.

<u>Background</u>: In February 2009, CESAME II decided to create a special task force (HSC WG) to review the possible options for the harmonization of settlement cycles across Europe. In its first meeting on 27 May 2009, the task force unanimously agreed that T+1 should be discarded as a possible option for the following reasons:

- FX issues
- Timing issues
- Cross time zone issues
- Back-office pressure

This paper will explain these issues in greater details.

<u>1) FX Issues</u>:

A move to a T+1 settlement cycle for securities trades would create significant problems for investors who use a different currency, and who would have to effect a foreign exchange transaction in order to buy or sell the amount of foreign currency that is required for a purchase of securities or that results from a sale of securities.

The current process for cross-border securities trading requires a spot foreign exchange (FX) transaction to fund the securities transaction in the currency of the trade. FX spot transactions settle in two days (T+2) and, currently, trades in European securities settle in two or three days (T+2 or T+3). Therefore, today, foreign investors can concurrently transact the securities and FX trade knowing that the currency of the trade will be delivered in time for the security transaction to be settled.

Under T+1 this would no longer be the case; transacted concurrently, the securities trade would be scheduled to settle before the spot FX transaction required to provide the currencies of the trade to fund the securities trade. To accommodate this settlement mis-match, foreign investors would be required to pre-fund their securities transaction, tap the T+1 or “Tom Next” FX market, or borrow the currencies of the trade.

All of these alternatives have implications of which investors should be aware; and each places foreign investors at an economic and operational disadvantage relative to peers who do not need to perform an FX to fund their trade. These disadvantages apply both to securities purchases and to securities sales for which the foreign investor would have, respectively, to buy and to sell foreign currency.

In July 2002, the FX Subcommittee of the US SIA issued a paper titled "T+1 White Paper" with a very detailed analysis of this issue.

2) Timing issues:

In many CSDs in Europe today, the daily settlement process starts with an overnight batch process that typically commences around 7:00 pm or 8:00 pm the previous evening. Following the overnight batch process, during which the majority of securities trades settle, there is a real-time settlement process that operates during the daytime hours, and finishes mid to late afternoon on the settlement day. This timetable is viewed as best practice, and TARGET2-Securities (T2S) will adopt this timetable.

The rationale for this timetable is that it maximises settlement efficiency, as it allows the bulk of standard securities trades to settle overnight, and it allows the full extent of the daytime hours to be dedicated to resolving settlement failures, and to processing settlement for non-standard trades (securities lending, collateral management, high value same day repo trades, etc).

Taking into account the overnight batch process, a move to T+1 would effectively mean that settlement process will start on the evening of trade day. All the activities that need to take place in advance of settlement will need to happen between the moment the trade is done and the end of the trading day. These activities include CCP netting activities, as well as the entire process of initiating, transmitting, matching and funding settlement instructions.

For CCPs, this will mean that in many cases they will be forced to process netting before the end of the trading day, thereby reducing the efficiency of netting.

For the process of transmitting securities settlement instructions, and given the very short time period, there is a risk that an important part of the trades will no longer be present in the CSD systems before the start of the night time cycle, and thus can no longer settle in the overnight cycle, but will tend to be shifted to the daytime settlement process. The consequences of such a shift should not be minimized: shift of use of computer resources from night to day, higher settlement failure rates (resulting from instructions that arrive too late for settlement, and from mismatched instructions for which there is less time to correct errors), a greater risk that there will be the need to activate contingency arrangements and extend the settlement day (with a significant negative impact on the payments infrastructure) given that there will be larger volumes of unsettled transactions close to the end of the settlement day, later availability of the cash resulting from settlement activity, etc.

3) Cross time zone issues:

A growing number of investors in European securities are located not in Europe, but in other parts of the world, such as the United States of America and Asia, and thus do not operate in the same time zone as Europe. Shortening of settlement cycles by moving to T+1 coupled with the timing issues described above, will create significant problems for these investors.

An asset manager based in the US is five to six hours behind Europe. If he wants to operate during normal business hours, he will start trading only in the European afternoon and would then – in a T+1 environment - have to rush to perform all post-trade pre-settlement activities in order to meet the overnight cycle deadline.

An asset manager based in Asia is seven to nine hours before Europe. If he wants to operate during normal business hours, he will trade in the European morning. Today he can perform all post-trade/pre-settlement activities the day after trade date without difficulty. In a T+1 environment, this would no longer be feasible and it is likely that he would have to perform these activities in the evening or night, outside of business hours.

In short, it will be very difficult for investors in other time zones to meet the requirements of a T+1 cycle. This will mean a significantly higher probability of late instructions, and of late settlement.

4) Back-office pressure:

In today's environment, back-offices have at least one day, if not two, to perform all the post-trade/pre-settlement activities. Many of these activities are still not completely automated. Paper, fax and phone calls are still widely used. The biggest challenge in shortening settlement cycle is to reduce the time given to back-office to perform all these activities. A move from T+3 to T+2 has highlighted this challenge and most of the efforts of the task force are concentrated in making recommendations to minimize the negative impact of such a move. Needless to say, what is a challenge when you move from T+3 to T+2, becomes a major problem if one has to move from T+3 to T+1. Risks related to a move to T+2 can probably be mitigated. Risks related to a move to T+1 are much more intractable.

An important point is that the risks and negative consequences of a move to T+1 apply not just to those investors whose back offices cannot handle the T+1 environment, but apply also to the market as a whole. Later settlement and a higher settlement failure rate resulting from some investors not being able to send their settlement instructions by close of business (European time) on trade date has a negative impact on all investors, as all investors will see their trades settling later, and will see some of their trades fail for reasons beyond their control.