

# Shorter settlement cycles: global alignment or fragmented markets?

## HOT TOPIC

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### Highlights

Analysis of the technological and operational changes required to move to a T+1 settlement period in the UK and EU, and the impacts of US T+1 on UK/EU market participants.

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### Summary

- Settlement cycle efficiency is a topic of focus for regulators and policymakers in several jurisdictions. The US, Canada and Mexico move to a T+1 (trade date plus one) cycle at the end of May 2024, and the UK and EU are also considering the case for shortening their settlement cycles.
- On 21 March 2024 the European Securities and Markets Authority (ESMA) published a [feedback statement](#) (the 'EU report') to its call for evidence on shortening the settlement cycle. On 28 March 2024, the [UK Accelerated Settlement Taskforce report](#) (the 'UK report'), and [Government response](#), were also published.
- The transition to T+1 in the UK and EU is likely to require significant investments in technology upgrades, systems and controls changes, staff training and compliance processes, and represents a major change programme affecting a wide range of market participants. It also presents opportunities for firms to make efficiency gains, automate processes and reduce costs.
- Policymakers are also assessing the potential unintended consequences of faster settlement, including increased fragmentation of markets, reduced or split liquidity pools, and deteriorated settlement efficiency.

### The current landscape

The majority of financial instruments in the UK and EU currently settle on a T+2 basis. Transactions in certain instruments fall outside of this market standard, however, including repos, mutual fund subscriptions and redemptions, and primary issuances.

The process of settling securities involves a large number of market participants including:

- buy-side investors
- intermediaries
- trading venues
- central counterparties (CCPs)
- custodians
- central securities depositories (CSDs), and
- settlement agents.

Firms may make use of third-party matching systems to match trade-level details.

The UK's CSD is Euroclear UK and International (EUI) which operates the CREST securities settlement system.

The EU post-trading landscape is more complex, involving a larger number of financial infrastructures, multiple currencies, and unharmonised national securities laws.

The UK report describes the range of 'horizontal' and 'vertical' processes involved in settlement chains and delineates between those processes that largely take place on trade date ('T') and those that occur on T+1 and T+2 under the current standards (see box 1 below).

The EU framework includes a settlement discipline regime that imposes cash penalties on market participants for settlement fails, while the UK's fining regime is based on overall performance rather than individual failed transactions.

Trade date ('T')	T+1, T+2
<ul style="list-style-type: none"> <li>• Allocation</li> <li>• Confirmation</li> <li>• Trade-level matching</li> </ul>	<ul style="list-style-type: none"> <li>• Processing of trades that take place late in the day on T</li> <li>• Settlement-level matching</li> <li>• Resolving exceptions</li> <li>• Managing securities inventory</li> <li>• Processes to reduce settlement fails</li> <li>• Cash management</li> </ul>

*Box 1: summary of UK post-trade process timings*

## Impacts of moving to T+1 in the UK and EU

The UK report describes the global nature of the UK's financial system and the benefits of moving to a faster settlement cycle, including greater harmonisation of market practices, improved resilience, reduced risks, and cost savings. The EU report also considers the potential benefits but notes that many of these are hard to quantify and that careful consideration needs to be given to the costs and potential unintended consequences of such a move.

Both reports highlight the significant operational impacts on market participants and the need for coordinated action to ensure the transition is managed effectively. Operational impacts include:

- **Automation of manual processes:** The EU report notes that T+1 would reduce the time available for post-trade processing by 80-90%. Processes that currently rely on higher levels of manual intervention are likely to require greater automation and 'straight through processing' (STP), given the reduced time to complete the necessary actions before settlement occurs. The EU report states that less liquid instruments and more complex operations imply a higher degree of manual intervention, and that wholesale market activity can be less automated and structured than retail activity. Greater automation will require firms to upgrade their technology and operational infrastructure; the UK report identifies processes that can lead to settlement delays including the use of non-machine readable communications sent via fax, email and PDF.
- **Treasury and inventory management:** UK and EU markets that operate on a 'delivery versus payment' model require market participants to have sufficient inventory available for delivery when needed. Given the reduced amount of time for post-trade processing under T+1, inventory management processes would need to be shortened. This could also lead to increased borrowing or hedging costs (see below).
- **Repo market activity:** Both reports find that the narrower window under T+1 presents particular challenges for repo transactions, which are not generally subject to a standard settlement cycle. Repo transactions can also lack standardisation and automation, leading to a need for significant improvement in processes under an accelerated settlement timeframe.

- **Mis-aligned settlement periods:** Both reports identify the potential impacts on market participants involved in trading multi-jurisdictional or multi-asset class financial instruments, in particular exchange-traded funds (ETFs) and mutual or open ended funds. The UK report notes that UK mutual fund subscription and redemption cycles currently range from T+1 to T+4 and that mis-aligned settlement cycles could create separate liquidity pools and cash or inventory drag. The report encourages the mutual fund industry to accelerate its fund settlement cycles to align with wider capital markets.
- **FX transactions:** The UK report explains that while there is no mandated legal or regulatory standard, the current settlement period for FX transactions is usually T+2, although T+1 or T+0 is possible albeit with higher associated costs. The CLS Settlement system offers multi-currency cash settlement for 18 major currencies on a netted basis, with a deadline of 11pm GMT for next day settlement.
  - Under current market practices, FX transactions are usually entered into after the underlying securities have been matched. Moving to T+1 for the underlying security would mean there would only be a few hours on T to execute the associated FX trade. Liquidity tends to be lower at the end of the day, particularly for non-major currencies, however.
  - The UK report outlines a number of possible choices for market participants, including pre-funding arrangements, settling FX trades on a gross basis outside the CLS system, using local third party providers to execute FX trades, and bringing forward the timing of FX trades (when the related securities trade may be unconfirmed).
  - Non-domestic investors will face similar FX challenges when the US moves to T+1 in May (see below). Both reports comment that the US experience will provide useful lessons for a UK or EU transition.
- **Settlement fails:** The EU report states that a reduced timeframe for completing post-trade processes could result in less transactions settling on the intended settlement date resulting in a higher number of cash penalties for settlement fails. However, the report notes mixed feedback from market participants on the likely increase in settlement fails (ranging from 5% to 80% in the short term) and whether such an increase would be temporary or permanent.
- **Other operational impacts:** Both reports highlight a range of other expected operational impacts which require consideration, including: repapering existing agreements and legal documentation, and changes to onboarding requirements; HR-related impacts such as altering the working hours of operational teams, or relocating or establishing teams in other jurisdictions; and changes to margin and collateral requirements.
- **Deprioritisation of other regulatory projects:** Both reports acknowledge the wider regulatory context the move to T+1 would take place within, and highlight the potential for deprioritisation of other regulatory projects by market participants in order to focus on T+1.

## Market standards and regulatory barriers

Various regulatory requirements would need to be amended to facilitate a move to T+1 in the UK or EU.

The securities settlement cycle is harmonised across the EU under the Central Securities Depositories Regulation (CSDR). CSDR mandates that transactions in transferable securities executed on trading venues must be settled no later than on the second business day after the trading takes place. CSDR was onshored under the EU Withdrawal Act 2018 and therefore also applies in the UK.

In the EU, cash penalties for settlement fails are mandated by the CSDR Settlement Discipline Regime Regulation. The EU report notes that market participants have suggested various articles related to measures to prevent settlement fails would need to be updated in preparation for T+1.

The UK has not implemented the EU CSDR Settlement Discipline Regime. In addition, under the Financial Services and Markets Act 2023 the UK CSDR will be revoked and new rule-making powers for CSDs have been granted to the Bank of England. The Bank of England has indicated it will commence work to review UK CSDR in due course.

Both reports discuss the impact that mis-aligned settlement cycles could have for UCITS funds that are prohibited from borrowing, on a temporary basis, more than 10% of their assets under the UCITS Directive. The UK report finds that consideration could be given to amending the UCITS rules to relax this borrowing cap. However, ESMA did not find sufficient evidence that legislative change is strictly needed to allow UCITS to deal with a T+1 settlement cycle. ESMA notes it will monitor market developments and consider whether actions or guidance are needed on this issue, however.

In addition to removing any regulatory barriers to T+1, the UK report recommends that, from 2025 onward, allocation, confirmation and trade-level matching processes should be mandated to take place on T in advance of the transition to T+1. The implementation date will be confirmed by the end of 2024.

The UK report also calls for market standards to be developed in various areas, including:

- processes for ensuring the onboarding of new accounts includes all the data needed to settle a trade
- settlement instructions to be sent on T
- standing settlement instructions (SSIs) to be sent in electronic format only
- extended operating hours for the CREST system, and an agreed cut-off time for T.

Both reports agree that efficient pre-trade matching would be needed under T+1. The EU report notes that mandating the use of a central matching platform would come with associated costs, however.

## Regulatory requirements affected by T+1 include:

- Central Securities Depositories Regulation (Regulation (EU) No 909/2014)
- The UK version of Regulation (EU) No 909/2014 (UK CSDR)
- The EU CSDR Settlement Discipline Regime (Commission Delegated Regulation (EU) 2018/1229)
- UCITS Directive (Directive 2009/65/EC).

## Timing and scope

**UK:** The UK report sets out a clear pathway for moving to T+1. In addition to recommending that certain pre-trade processes should be mandated to take place on trade date in 2025, it states that the UK should transition to T+1 before the end of 2027. The UK government has accepted the report's recommendations.

Following publication of the initial report, a Technical Group has been established to develop the technical and operational changes necessary for the UK to transition to T+1, and agree specific deadlines.

One of the technical issues the group has been asked to consider is the development of a 'safe harbour mechanism' to address mis-aligned settlement cycles for securities that trade in the UK but settle elsewhere. The UK report states that the CSDR Article 5(2) carve-out could be a potential solution for this issue.

**EU:** ESMA concludes that transition to T+1 could take place no earlier than 32 months following announcement of the change. ESMA finds that EU CCPs could be ready within 18-24 months, however.

While ESMA notes the desire among market participants for alignment with other jurisdictions, it also highlights feedback that indicates remaining on T+2 while others move to T+1, at least in the short term, is a viable option.

**T+0 and atomic settlement:** The reports strike a noticeably different tone on the possibility of moving to T+0, or atomic settlement (which can be defined in several ways).

The EU report notes strong feedback from respondents that the cost of moving to T+0 or any form of atomic settlement would largely outweigh the benefits and would not be achievable in the short to medium term. ESMA states it agrees with this feedback, effectively ruling out any consideration of T+0 in the EU for the foreseeable future.

The UK report is more open to this possibility, however, noting that T+0 or atomic settlement is technically possible today. The report encourages firms to have in mind a move to T+0 when investing in systems and processes to enable T+1.

## Impacts of US T+1

ESMA's call for evidence asked a number of questions about the likely impact on EU market participants of the US move to T+1. The UK report also considers this issue in detail. Key impacts for UK and EU market participants include:

- **Time difference:** The EU report highlights the limited overlap between when US and UK/EU markets are open, and market participants report that trading in EU markets tends to be higher during those common hours. The time differences between the markets means T+1 will exacerbate the shorter time frame available to complete the necessary post-trade processes.
- **Funding gap:** Consistent with other non-US jurisdictions, UK and EU market participants that transact in US financial instruments will face a funding gap (i.e. having to pay for a security sooner than receiving the cash from the investor), requiring borrowing to cover that gap. Mis-aligned securities and FX settlement cycles could also increase FX risk, leading to increased costs.
- **Split liquidity:** The UK report notes that securities that are traded outside the country of issuance ('XS ISINs') may be subject to either T+1 or T+2 settlement cycles depending on where they are traded, resulting in split liquidity. The report sets out several models to address this issue but recommends the Technical Group considers how to address it within a UK context.
- **Separate workflows:** The EU report suggests that for ETFs, multi-listed securities and depository receipts, separate workflows may be required for different settlement cycles, leading to additional costs and complexities.
- **Corporate actions:** The EU report notes industry concerns over corporate actions in relation to shares listed in the US and the EU. Should the EU remain on T+2, the record date and the ex-date - which determine the entitlement to distributions - will differ, with additional implications for tax processing. The report recommends that a standard industry practice should be established soon.
- **Decrease in settlement efficiency:** The EU report finds that the adoption of T+1 by other jurisdictions (as well as in the EU) could lead to a decrease in settlement efficiency in certain areas, in particular for ETFs, repo activity and reduced use of the CLS settlement system.

Both reports note that UK and EU market participants will be able to learn lessons from the US transition and that their adaptation of processes to account for the shorter North American settlement cycle should ease the transition to UK and EU T+1. The EU report warns, however, that only market participants that actively trade in the US will be able to leverage their experience and that smaller market participants may not feel this benefit.

Mis-alignment between US and UK/EU settlement cycles will create additional complexity, costs and operational risks for market participants that are active in US markets.

The impact will not affect all firms equally, however. UK and EU authorities have committed to learning the lessons of North America's move to T+1 when considering the technical and operational issues for T+1 implementation in their respective markets.

### What does this mean for firms?

UK and EU authorities agree on the scale of the operational impact that moving to T+1 would have on market participants, and the need for strong coordination between regulators and industry.

The UK report sets out five phases of work that will be needed to adopt T+1 settlement:

- making the required regulatory and rule changes
- industry engagement
- implementation
- testing
- transition.

Given the certainty over the transition provided by the UK report, firms can begin preparing for the change, allocating budgets for investment in new automation in 2025, and establishing governance and oversight processes.

The EU report is less unequivocal and notes the need to better understand a range of issues before ESMA can assess the appropriateness of shortening the settlement cycle. EU firms that are active in overseas markets will need to consider how shorter non-EU cycles will affect their processes, systems and controls, and should closely monitor this issue for further developments going forward.

Issues for firms to consider include:

- **Uneven market impact:** The costs and benefits of T+1 will be felt differently by industry. Larger market participants may be able to leverage their experience of adapting to the US move to T+1, or may have local offices in North America which reduces the operational impact, while smaller market participants may not. Smaller firms may also currently utilise automated processes to a lesser extent.
- The EU report asserts that the impact will be greater for firms that are further away from end settlement in the custody chain, those that trade multi-settlement instruments, and those that are involved in non-standardised transactions such as repo and loan agreements and complex corporate actions.
- Sector-specific issues for firms to consider include;
  - **Asset managers** should consider the impacts of T+1 on their subscription and redemption periods, borrowing and funding requirements, and workflows for managing multi-settlement instruments.

- **Intermediaries, market makers and custodians** should consider their inventory management processes, liquidity needs, client onboarding requirements, and processes for communicating both 'horizontally' and 'vertically' through the trade and settlement information flows.
- **Market infrastructures** should consider their operational resilience and capabilities under a faster settlement cycle. Regulatory requirements may also require amendments to operating hours and member rulebooks.
- **Process and systems upgrades:** T+1 will affect a wide range of systems and processes, including trade execution, processing, financing, payments and inventory management. Technology-enabled processes, STP, and a reduction in frictions that can lead to settlement delays will be needed to achieve efficient settlement under a T+1 standard. Firms should holistically review their processes, systems and controls to identify areas where operational efficiencies can be made, and begin to plan for compressed timeframes from 2025 onward. Firms should also monitor developments in relation to mandatory pre-matching.
- **Opportunities for investment and efficiency gains:** The benefits of greater automation and investment in back office processes are highlighted throughout the UK report, including improved efficiency and productivity and a reduction in manual errors that can lead to settlement fails. Firms should consider reviewing their processes to identify the root cause of any frictions and ways of optimising their workflows. Any client or counterparty behavioural changes that may be needed should also be considered. Firms may also benefit from reduced margin and collateral requirements on transactions clearing through a CCP.
- **One-off and longer-term costs:** Quantifying the costs of T+1 is challenging and will vary from firm to firm; the UK report notes that estimates of the cost of preparing for the US T+1 varied widely ahead of the transition. Firms should prepare for the costs of T+1 to include significant investment into technology upgrades, testing and controls costs, and implementing real-time solutions. Depending on firms' existing organisational set-ups, staff costs associated with longer operating hours or new hiring requirements could also be felt. Firms should delineate between one-off costs such as infrastructure transformation, re-papering of existing documentation and testing, and longer-term costs which could include HR-related, funding, or regulatory driven changes (e.g. an increase in settlement fail penalties).
- **Indirect effects:** Firms should also take note of the wider context in which the move to T+1 is taking place. Firms should consider how possible indirect effects such as increased harmonisation of practices globally and fragmented markets and/or liquidity pools, and the trend towards increased automation and use of new technologies such as blockchain and generative AI, could affect their longer-term business and growth plans.

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## Next steps

The UK Technical Group will report its findings and recommendations by the end of 2024. This will include recommending a date for the UK to move to T+1 at no later than 31 December 2027, and a date in 2025 for certain pre-trade processes to be mandated to take place on trade date.

ESMA will publish its report assessing the appropriateness of shortening the settlement cycle, and the costs and benefits of doing so, in Q3/Q4 2024.

Both jurisdictions will incorporate lessons learned from the North American transition to T+1, which takes place at the end of May 2024.

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