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Response to ESMA's Call for evidence on shortening the settlement cycle (ESMA74-2119945925-1616)

The Norwegian Securities Dealers Association is a national trade organisation for investment firms.

Q1. Please describe the impacts on the processes and operations from compressing the intended settlement date to T+1 and to T+0. Please:

(i) provide as much detail as possible on what issues would emerge in both cases and how they could be addressed with special attention to critical processes (matching, allocation, affirmation and confirmation) and interdependencies. Where relevant please explain if these are general or asset class/instrument/ trade specific.

(ii) (ii) Identify processes, operations or types of transaction or financial instrument class that would be severely impacted or no longer doable in a T+1 and in a T+0 environment.

Please, suggest if there are legislative or regulatory actions that would help address the problems. Where relevant please explain if these are general or asset class/instrument/ trade specific.

(I)

In considering the potential compression of the settlement cycle to T+1, it is currently deemed challenging to directly transition to T+0 without first implementing T+1. ***Therefore, our response will focus on the impacts associated with a move to T+1.***

The shift to T+1 poses a greater challenge for our members compared to the previous move from T+3 to T+2. The reduced time for post-trade services requires careful evaluation, and we recommend studying the go-live experience in the US and Canada before deciding on T+1.

The European market faces unique challenges in adopting T+1, in comparison to the North American markets. The presence of multiple CSDs, trading venues, and CCPs introduces fragmentation on different levels. Additionally, the existence of multiple currencies in Europe, *especially for our members operating in Norway and other Nordic countries, underscores the importance of compressing the settlement cycle on the FX market to T+1. This step is crucial to maintain market attractiveness and prevent potential pre-funding requirements that may deter investors.*

Furthermore, achieving synchronization across all financial instruments, including derivatives and ETFs, on the same settlement cycle is essential for market efficiency.

From a post-trade perspective, compressing the settlement cycle to T+1 entails significant changes. Immediate actions, such as asset allocation for settlement and confirmation creation, will be required right after the trade is executed. Settlement instructions and fund transfers in different currencies must occur on the trade date or possibly in the morning on T+1.

With a shorter timeframe between the trade date and the intended settlement date, there is an expectation of decreased settlement rates and potential increases in penalties under CSDR. Challenges may arise from delays in counterparty static data setup, financial instrument setup, and mismatches between different sources. Efficient communication within and outside the institution will be crucial for addressing unmatched trades and resolving issues with other market participants, infrastructure providers, and customers.

Contingency plans become paramount in this scenario, with a need for stringent measures to handle situations where market participants encounter IT problems, given the reduced window of opportunity to resolve such issues.

(II)

In a T+1 environment, no processes are deemed impossible, but security lending would be severely impacted as trades are often booked on T+1, and a T+1 cycle would compress this to T+0. Cross-border trade settlement, being non-automated, could face increased risk, but with additional system support, it remains feasible. ADRs might be challenging on T+1 due to different time zones and FX components. It's crucial for consistency that various financial instruments and asset classes share the same settlement cycle, particularly for derivatives tied to underlying instruments.

Q2. What would be the consequences of a move to a shorter settlement cycle for (a) hedging practices (i.e. would it lead to increase pre-hedging practices?), (b) transactions with an FX component?

Please refer to answer on Q1 regarding ADRs and derivatives.

Q3. Which is your current rate of straight-through processing (STP), in percentage of the number and of the volume of transactions broken down per type of transaction or per instrument as relevant? In case STP is used only for certain processes/operations, please identify them. Which are the anticipated challenges that you envisage in improving your current rate of STP?

The settlement process for Norwegian equities, specifically those registered in the local CSD and involving Norwegian participants, achieves close to a 100% STP rate. Notably, in Norway, the use of segregated accounts is mandatory for all domiciled individuals and corporations. The clients may have several accounts with different institutions. We recognize that the "release process", ie releasing securities from one institution to another before transferring cash, will require increased automation.

The STP rate on cross-border transactions is far lower. This is mainly because such transactions involve an FX component.

Q4. Please describe the impacts that, in your views, the shortening of the securities settlement cycle could have beyond post-trade processes, in particular on the functioning of markets (trading) and on the access of retail investors to financial markets. If you identify any negative impact, please identify the piece of legislation affected (MiFID II, MiFIR, Short Selling Regulation…) and elaborate on possible avenues to address it.

In general, reduced counterparty risk should lead to lower margin requirements and hence free up liquidity for the intermediaries. Isolated, reduced cost of collateral could benefit the end clients through reduced settlement fees.

When it comes to securities listed on different markets, we could see a concentration of liquidity in one market due to post trade processes, especially if the markets operate on different settlement cycle.

Q5. What would be the costs you would have to incur in order to implement the technology and operational changes required to work in a T+1 environment? And in a T+0 environment? Please differentiate between one-off costs and on-going costs, comparing the on-going costs of T+1 and T+0 to those in the current T+2 environment. Where relevant please explain if these are general or asset class/instrument/ trade specific.

Our members anticipate higher ongoing personnel costs in transitioning to a T+1 environment. This is attributed to extended working hours for front office staff required to complete trade bookings on the trade date. Additionally, increased personnel in operations are needed to promptly address potential technical and systems-related issues, as well as to rectify unmatched trades. It's noteworthy that the compression of the settlement cycle itself isn't the primary challenge; rather, the time difference between markets poses a significant hurdle.

An indirect consequence could be required for banks to extend opening hours related to payment transactions, contributing to increased costs in the settlement chain.

Moreover, it is crucial to assess the impact of expected costs arising from reduced settlement efficiency, including heightened funding costs and settlement penalties. Further details on this aspect are provided in response to question 6.

It is impossible to provide any estimates on one-off cost at this stage.

Q6. In your view, by how much would settlement fails increase if T+1 would be required in the short, medium and long term? What about T+0? Please provide estimates where possible.

In the Norwegian market, the current settlement rate stands at approximately 97%. Estimating the impact of a compressed settlement cycle on settlement fails is challenging. However, our members suggest that in the short term, the settlement rate may decline by around 10 percentage points, reaching a level of approximately 87-90%.

Q7. In your opinion, would the increase in settlement fails/cash penalties remain permanent or would you expect settlement efficiency to come back to higher rates with time? Please elaborate.

The expectation is that settlement efficiency will experience an immediate decline, accompanied by a rise in penalties. However, the belief is that this decrease will not be a permanent state. The incurred costs and disruptive effects associated with settlement fails will incentivize all parties to actively seek improvements and enhance the efficiency of processes. The extent to which rates may increase is closely tied to how non-domestic parties align their processes with the local market requirements. Our members believe that it may take several years before settlement rates are back on T+2 levels.

Q8: Is there any other cost (in particular those resulting from potential impacts to trading identified in the previous section) that ESMA should take into consideration? If yes, please describe the type of cost and provide estimates.

Please refer to our answer on question 5. We would like to add that increased costs, both one-off and ongoing, will hurt the small market participants most. If the increased costs result in small participants retiring from the market, this will affect the competition and may lead to higher costs for investors.

Q9: Do you agree with the mentioned benefits? Are there other benefits that should be accounted for in the assessment of an eventual shortening of the securities settlement cycle?

In general, we agree with ESMA's acknowledgment of the theoretical benefits associated with moving to a shorter settlement cycle.

Q10: Please quantify the expected savings from an eventual reduction of collateral requirements derived from T+1 and T+0 (for cleared transactions as well as for noncleared transactions subject to margin requirements).

In theory, we align with the expectation of savings resulting from a potential reduction of collateral requirements in a T+1 settlement cycle. Our members suggest a reduction in the range of 20-25% for initial margin requirements. Additionally, there is the possibility of decreased contributions to CCPs default funds due to lower counterparty risk. It is essential to emphasize that further in-depth analysis is required to gain a comprehensive understanding of the potential reductions in this area.

Q11: If possible, please provide estimates of the benefits that you would expect from T+1 and from T+0, for example the on-going savings of potentially more automated processes.

We are not able to provide estimates on this. It is hard to isolate the potential savings due to more automated processes, when the overall picture is the cost will increase. It must also be noted that we already have a high settlement rate in our market.

Q12: How do you assess the impact that a shorter settlement cycle could have on the liquidity for EU markets (from your perspective and for the market in general)? Please differentiate between T+1 and T+0 where possible.

In alignment with our response to question 4, the impact of a shorter settlement cycle on market liquidity, especially for stocks with dual listings, could be significant. Challenges may arise from shifts in market liquidity across different time zones and settlement cycles, influencing certain aspects of market structure. Further, the preferences of larger buy-side clients in terms of how, where, and when they execute orders may undergo changes, potentially exerting a negative impact on both overall total liquidity and intraday liquidity.

Q13: What would be the benefits for retail clients?

Retail clients would experience faster receipt of securities or cash from their transactions. Additionally, the shortened settlement cycle is likely to result in accelerated interest and dividend payment cycles. These improvements align with the growing demand for more instantaneous services from the retail customer base.

Q14: How would you weigh the benefits against the costs of moving to a shorter settlement cycle? Please differentiate between a potential move to T+1 and to T+0.

Compression of the settlement cycle entails a trade-off between reduced counterparty risk versus increased operational risk and cost. Balancing these factors is challenging. Maintaining a longer cycle than other markets would undermine European competitiveness and is not a viable option.

Q15: Please describe the main steps that you would envisage to achieve an eventual shorter securities settlement cycle. In particular, specify: (i) the regulatory and industry milestones; and (ii) the time needed for each milestone and the proposed ultimate deadline.

Success factors for achieving a shorter securities settlement cycle include enhancing straight-through processing efficiency and streamlining the acquisition of standardized settlement instructions (SSIs). While reducing market opening hours could facilitate the process, it may face resistance from market participants due to concerns related to overlapping opening hours in different markets, due to different time zones.

Q16: Assuming that the EU institutions would decide to shorten the securities settlement cycle in the EU, how long would you need to adapt to the new settlement cycle? And in the case of a move to T+0?

Our members estimate two years to adopt to T+1. T+0 is more difficult to assess, but our members suggest a period of four years.

Q17: Do you think that the CSDR scope of financial instruments is adequate for a shorter settlement cycle? If not, what would be in your views a more adequate scope?

Yes, all instruments in the CSDR scope should be included. Further, as mentioned in our answer to question 1, we believe synchronization of settlement cycle across all financial instruments, including derivatives and FX, is vital.

Q18: Is it feasible to have different settlement cycles across different instruments? Which are the ones that would benefit most? Which least?

No, it is not feasible to have different settlement cycles across different instruments.

Q19: Which financial instruments/ transaction types are easier to migrate to a shorter settlement period in the EU capital markets? Does the answer differ by asset class? Should it be feasible/advisable to have different migration times for different products/markets/assets? If yes, please elaborate.

In line with our answers above our members would prefer that all markets and asset classes are migrated at the same point in time.

Q20: Do you think that the settlement cycle for transactions currently excluded by Article 5 of CSDR should be regulated? If you think that the settlement cycle of some or all of these transactions should be regulated, what would be in your view an appropriate length for their settlement cycle?

No.

Q21: Please describe the impact(s) that the transition to T+1 in other jurisdictions has had or will have on your operations, assuming the EU remains on a T+2 cycle.

The most significant challenge is the timing misalignment between the different jurisdictions. Market participants in the EU face the hurdle of a compressed time window between trade execution and settlement, leading to operational complexities. Notably, this impact is more pronounced for FX transactions, cross-border trades, and liquidity management.

The transition to T+1 in other jurisdictions requires additional operational adjustments and may introduce system complexities, potentially increasing costs and operational challenges for entities engaged in cross-border transactions between the EU and the US. This shift could also give rise to concerns related to Corporate Actions events for instruments with multiple listings, requiring a standardized approach to prevent discrepancies in ex/record dates across different markets.

Anticipated changes in trading dynamics may include a concentration of market liquidity for securities tradeable across multiple markets in one settlement cycle. Consequently, there's a real risk of market liquidity for dually listed securities shifting to the US market, presenting potential implications for European markets.

Q22: Can you identify any EU legislative or regulatory action that would reduce the impact of the move to T+1 in third countries for EU market participants? Please specify the content of the regulatory action and justify why it would be necessary. In particular, please clarify whether those regulatory actions would be necessary in the event of a transition of the EU to a shorter settlement cycle, or they would be specific only to address the misaligned cycles.

No.

Q23: Do you see benefits in the harmonisation of settlement cycles with other non-EU jurisdictions?

Harmonizing settlement cycles with key markets like the US and UK offers numerous advantages for EU Capital Markets. This alignment would simplify operational processes and decrease complexity for EU participants engaging with counterparts in these non-EU jurisdictions. Additionally, aligning with the most liquid capital markets could incentivize smaller non-EU jurisdictions to follow suit, enhancing overall harmonization for EU participants.

Q24: Would reducing the settlement cycle bring any other indirect benefits to the Capital Markets Union and the EU's position internationally?

In general, more efficient post trade processes reducing risk, and freeing up liquidity will improve the attractiveness of the EU Capital Markets compared to T+2 jurisdictions.

Q25: Do you consider that the adaptation of EU market participants to the shorter settlement cycles in other jurisdictions could facilitate the adoption of T+1 or T+0 in the EU? Please elaborate.

Aligning with the shorter settlement cycles in other jurisdictions would require adjustments to settlement processes to accommodate their timelines. Notably, the changes implemented for these jurisdictions are likely to mirror the modifications necessary for a broader adoption of T+1. This alignment reduces the additional cost of operating in markets with shorter settlement cycles, potentially facilitating the broader adoption of T+1 or T+0 in the EU.

Q26: Would different settlement cycles in the EU and other non-EU jurisdictions be a viable option?

No, not as a permanent state.

Q27: Please elaborate about any other issue in relation to the shortening of the securities settlement cycle in the EU or in third-country jurisdictions not previously addressed in the Call for Evidence.

As mentioned above our response in this call for evidence has been focused on a move to T+1. We believe a move to T+0 would be very complex for the fragmented EU markets, and we do not regard T+0 a viable option currently.

Yours Sincerely,

The Norwegian Securities Dealers Association

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