Optiver

Insights

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Market Structure

T+1: The case for one-day settlement in Europe

A US plan to halve the trade settlement period to a single day has brought post-trade infrastructure back into the conversation. We encourage Europe to follow the US's lead and move to T+1 settlement, but we caution that there are numerous complexities to iron out.

Not so long ago, Europe was at the forefront of changes to the post-trade process. In October 2014, ahead of new rules for financial markets, the European Union slashed the time for securities and cash to change hands from T+3 to T+2. Counterparties accustomed to having to wait three days for trades to settle were now able to complete them in two. The US, following Europe's lead, made the move to T+2 in 2017.

This time it's the US taking the lead. Under newly proposed rules from the SEC, the US will move to T+1 settlement by May 2024. That means counterparties will have to wait just a single day for trades to settle. Other markets are already springing into motion. India implemented T+1 settlement in January while Canada will make the switch in May 2024 alongside the US. The UK's Accelerated Settlement Taskforce plans to decide on the matter by December 2024.

We argue that Europe should also make the move to T+1, particularly as it could put the region at a competitive disadvantage if it doesn't do so. But we caution that the fragmented nature of European markets poses unique challenges to such a move. Authorities should carefully consider these challenges to avoid unintended consequences.

Background

While post-trade is rarely top of mind for market participants, calls for one-day settlement reached the mainstream during the January 2021 "meme-stock" craze in the US. After clearinghouses hiked margin requirements in response to sudden and extreme price moves in US shares, retail brokers like Robinhood halted trading in some of these names. This in turn triggered a backlash from retail investors claiming they were unable to cash out and lock in profits.

Following the incident, Robinhood CEO Vlad Tenev led calls for a shorter settlement window, arguing that such a move would have prevented the situation from unfolding.

Although Europe's retail boom was less pronounced, many market participants in the region also began to wonder aloud whether such a change was overdue.

Benefits and Risks

Put simply, a shorter settlement window reduces risks to the financial system. The less time it takes for cash and securities to change hands after a trade is agreed, the slimmer the chance of a counterparty defaulting or failing to meet its obligations. Halving the settlement period would also decrease the time market participants need to hold capital and post margin at clearinghouses to cover open exposures. The reduced capital burden would free up cash and help market participants during volatile periods.

The move to T+1 would also help streamline settlement, limiting delays and fails. For example, trade affirmations would need to be communicated and verified on the trade date, reducing the chance of errors in the long term. As the US plan will likely spur a global trend toward T+1, Europe following suit would help its financial markets remain competitive on the world stage.

While moving to T+1 would reduce risks overall, it wouldn't eliminate them entirely. A shorter settlement window gives market participants fewer opportunities to resolve issues that may arise. One way to minimize these risks is for European authorities to adopt a clear and comprehensive plan for moving to T+1. That means coordinating across the dozens of national clearing houses and central securities depositories that operate across the region.

Here are some of the major issues European authorities need to consider:

- T+1 could lead to more complicated cash-management for trades with an FX component, given that currency markets work on two-day settlement.
- There would be less time to resolve processing errors. This includes a shorter window for sourcing liquidity from the securities-lending market to cover short positions, which could be particularly impactful when hunting for less-liquid stocks. For example, firms doing short sales late in the trading day will have little time to locate the securities needed to cover their positions. This could be particularly acute for illiquid stocks or where borrowed securities and short-sale transactions are located in different depositories.
- As the market adapts to a new settlement regime, there could be an initial spike in delayed or failed trades, which could raise costs and impact liquidity.

Another issue particularly relevant for Europe is depot switches – the practice of moving securities traded in multiple jurisdictions to different CSDs. Depot switches are commonly used in Europe to manage inventory as part of liquidity-provision strategies, given the multitude of dual-listed stocks and depository receipts.

For example, a market maker may need to move inventory in Royal Dutch Shell, which is listed on both Euronext Amsterdam and the London Stock Exchange, from the Dutch securities depository (Euroclear Nederland) to the UK (CREST) in order to cover a short position. A shorter settlement window means these switches could lead to trade failures if they're not processed efficiently.

Our Recommendations

Without a coordinated approach by authorities, the issues outlined above could easily spark a wave of late or failed trades. That could in turn lead to regulatory fines under the EU's Central Securities Depository Regulation or punitive buy-in costs imposed by clearing houses. These costs would be particularly onerous for market makers and could result in these firms compensating for potential penalties by quoting wider prices or in smaller size.

To mitigate the impact on liquidity, EU regulators should consider harmonised buy-in exemptions for market makers, at least on a temporary basis. To solve the issue of depot switches, authorities could set a maximum processing time, for example 30 minutes from the time an instruction is received, for CSDs to handle a depot switch.

Finally, cooperation between the EU, UK and Switzerland is critical to ensure Europe's capital markets remain competitive. We recently argued that fragmentation among EU Member States remains a key hindrance to improving the region's global standing. Different settlement cycles within Europe would only exacerbate this challenge.

This is by no means an exhaustive list of the challenges that authorities need to consider. We're convinced however that with proper planning and industry support, one-day settlement would be a boon for European markets.

About Optiver

Optiver is a global market maker with offices in Amsterdam, London, Chicago, Austin, Sydney, Shanghai, Hong Kong, Singapore and Taipei. Founded in 1986, today we are a leading liquidity provider, with close to 2,000 employees in offices around the world, united in our commitment to improve the market by competitive pricing, execution and thorough risk management. By providing liquidity on multiple exchanges across the world in various financial instruments we participate in the safeguarding of healthy and efficient markets. We provide liquidity to financial markets using our own capital, at our own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, bonds and foreign currencies.