

T2S Wave 1 – Review and Request for Action Following Migration of Italian Market to T2S

Introduction

T2S went live on 20th June 2015 with four Central Securities Depositories (CSDs). On 31st August, the Italian CSD, Monte Titoli, migrated to the ECB's settlement platform. This paper, compiled by AFME, with ICMA input, outlines various issues encountered by their members during the migration of the Italian market to the T2S platform.

The document is intended to provide feedback which may help the T2S team, future wave CSDs, and all investors understand the specific elements which did not function as expected. There were clearly issues between the investors and their clients whilst others related to initial problems at the CSD and T2S. We recognise the settlement process for future waves will not be identical to the Italian market although we believe that lessons can be learned by many parties. The aim of this paper is to highlight and help reduce similar issues in upcoming migration waves. Particular focus should be given to the next two T2S migrations proposed for March and September 2016 which include the CSDs of Belgium (NBB and Euroclear), France, the Netherlands and Portugal.

Finally, we acknowledge that the vast majority of the migration was a success and congratulate the T2S team and the four CSDs in the initial wave and LSE Group. We trust that this report will be read in the spirit of cooperation and collaboration that it is intended to foster.

Issues reported during the Italian migration

The market had considerable issues with Standard Settlement Instructions (SSI) and matching

There was a late realisation by end user clients of the need for static data changes. This left very little time for the market to understand and adapt to the changes. The issue was particularly evident in fields Party 1 and Party 2. Members reported seeing at least eight different variations of these completed fields which left many trades in an unmatched status.

Proposed action: Markets to analyse SSI formats and publish requirements at least three months before go-live.

Association for Financial Markets in Europe

London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

www.afme.eu

Greater clarity and transparency is required from markets and their participants about all matching criteria.

Where there is a fundamental change of SSIs, the full details must be made available at least one month before go-live and clients should be actively encouraged to share these details with their banks/brokers, preferably in advance of the migration. A precise formatting convention should be issued as the terminology used was confusing. A single source of data housed within the CSD would be available to the public to help resolve and reduce these issues.

Proposed action: Active messaging and tracking from custodian community to their underlying clients for completion of SSI changes.

We recognise that market participants have a role to play to ensure that their clients understand how the SSI structure will change and to ensure that all clients update the relevant records in advance of the migration wave. Although this process was undertaken prior to the Italian migration, greater emphasis should be placed on this topic by market participants and we call on future wave CSDs to provide a database, available to all, of participant codes and Party 1 identifiers.

Proposed action: Future wave Domestic CSDs to take responsibility of working with local agents to provide a single consolidated list.

Settlement Issues not related to SSI

Users reported a lack of matched status instructions at certain times during the first few days. We believe that this was a CSD-related issue which resulted in ICPs not receiving a status for some considerable time after the trade was instructed. Clients were not aware of the status of their trades and could not confidently predict their settlement and required funding. Monte Titoli recognised the issue (subscription to a T2S service) and updated their status overnight on 31st August. It is likely that the transactions reported with a lack of a matched status were due to the backlog of transactions.

We noted that Central Counterparties (CCPs) applied settlement fines as required under the Short Selling Regulation. We remained in close contact with Monte Titoli and were grateful that they were able to waive the penalties at the settlement level. However, the potential for a buy in of equities remained. During a migration period we consider the suspension of the Short Selling Regulation to be paramount. This would require interaction between the CSDs, National Competent Authorities, and possibly the

Association for Financial Markets in Europe

London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

www.afme.eu

European Commission. However, the suspension of such a Regulation until normal market conditions return appears a sensible and reasonable request to regulators.

Proposed action: Future wave CSDs to ensure rigorous testing to avoid replication of the matched status issue.

Proposed action: CCPs, in conjunction with their National Competent Authorities, to consider the suspension of the Short Selling Regime during a migration wave until normal market conditions resume.

We noted that large fixed income trades took longer to settle causing a shortage of settlement liquidity. This has been partially relieved with the introduction of partial settlement windows in the morning. A re-introduction of the shaping functionality or another efficient fails recycling process by CCPs or CSDs in the overnight cycle would further increase bond liquidity.

Proposed action: Response from CSD and CCPs, in conjunction with the T2S team, regarding the feasibility of re-introducing either shaping or other fails recycling functionality. We recognise that this would require the consent of all CSDs and a harmonised structure across the markets.

Cash and repo trades executed for a specific set of fixed income instruments with a coupon pay date of 1st or 2nd September 2015 were allocated an incorrect calculation of accrued interest and, thus, settlement counter values were not as expected at Monte Titoli, the Italian CSD. Monte Titoli advise us that there was an incorrect calculation on 31st August which was remedied the following day.

Proposed action: CSDs to check that test cases include and check all types of instrument.

The Auto Collateralisation process did not appear to work as expected for some parties. This, together with an initial lack of the additional partialling functionality, caused Central Counterparties (CCP) to inject significant liquidity into the system. This is a serious concern for members who often rely on their settlement agents to ensure sufficient liquidity is available i.e. take an intraday line from agent bank. Ahead of future migration waves, agents and their clients should review liquidity requirements in light of Auto Collateralisation, revised local market practices and the T2S rules. Users of the systems and providers of liquidity must fully test this functionality to avoid any substantial additional funds by the CCPs due to a lack of liquidity.

Association for Financial Markets in Europe

London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

www.afme.eu

Proposed action: DCPs and custodians in future waves to confirm this functionality is included in their test plans. Liquidity requirements should be reviewed during testing.

Proposed action: CSDs to highlight main changes from current state to future T2S state to their participants.

Proposed action: T2S team to assure the markets that this functionality is fully operational and available to all users.

Members noted a delay in cross border settlements (i.e transactions between a T2S and a non T2S participant), during the first week. When a CSD receives a cross border instruction, it is forwarded to the non T2S CSD and T2S. In the case of Italy, Monte Titoli could only send acknowledgments of instructions once they received the same from T2S, and only for all instructions sent in the same file. Upon migration, the agreed time delay for this process was five minutes (as it was pre-T2S). However, as we understand the process, this cross border instruction processing in T2S took longer than five minutes. This caused the sender's file to be "timed out". The issue was resolved although the cause remains unclear.

Proposed action: A CSD's client should receive status updates on a regular basis. The processing delays should be set accordingly to prevent this issue, possibly on a CSD by CSD basis. We call on CSDs in future migration waves to provide an assurance an identical issue of "timing out" will not be repeated.

Testing

We believe that some form of wider testing would be helpful although we recognise that time is short and the mandatory testing must be completed first. However, the lack of available slots during testing windows was a concern. As with any large project, we recognise that there will be some initial set up difficulties. However, these must be kept to a minimum to allow all participants (T2S, CSDs, DCP and ICPs) sufficient time to complete their testing.

Proposed action: T2S to confirm if wider testing windows can be incorporated into future waves.

Proposed action: High quality market level coordination required by CSDs in relation to Community Testing.

Although we understand that Monte Titoli provided regular updates to DCPs and the Italian banking community, it would have been helpful for pan-European investors to

Association for Financial Markets in Europe

London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

www.afme.eu

access a central log of go-live issues and with a daily status report updated on the T2S website. A better view from the local market participants about their plans for the first weekend and post migration would also have provided helpful information. (n.b. Monte Titoli was very helpful in providing their daily insight to AFME which was relayed to members).

Proposed action: future wave CSDs in conjunction with T2S team to advise if the above status reports could be made available.

The implementation of partial windows was communicated by the CSD after it was implemented. We recognise that partial windows were introduced promptly by T2S and with the best of intentions. In future we would support and recommend clear communication throughout the chain if such changes are to be made as this information is vital for the community to make best use of these modifications.

Proposed action: AFME would like to confirm with T2S that the partial cycles will be available to all future wave CSDs, and confirm with the CSDs that they intend to use them.

Settlement Rates

Settlement rates in the Italian market were not immediately available. As members use these rates for benchmarking purposes, this data is important. We are interested to understand what were the issues preventing accurate calculation by Monte Titoli, and how future migration wave CSDs plan to cater for the publication of settlement rates. Additionally, the calculation of settlement rates would be more reflective of the market if unmatched transactions were included in the calculation. We understand that the Italian market only uses matched trades to calculate the settlement rate.

Proposed action: Monte Titoli to advise.

Changes to Behaviour

The lack of a net daily settlement cycle in T2S is a behavioural change that all parties will need to understand. Unsettled transactions in the overnight cycle are settled individually during the daytime settlement cycle. If an agent has a flat position but has deliveries and receipts for the same ISIN, the trades remain unsettled unless a pair off is agreed. The two windows for partialling in the morning only partly resolve the situation and it is not clear how T2S could be changed in the short term. Therefore participants and their clients must be aware of this issue and amend their settlement practices accordingly. For the next migration waves, members have suggested the introduction of a net daily settlement cycle (e.g. at SD from 8:00 to 13:00) and a more

Association for Financial Markets in Europe

London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

www.afme.eu

efficient fail recycling process. However, if introduced, we recognise that a harmonised approach would be required across all CSDs.

Proposed action: Settlement rates have continued to improve suggesting the market has adapted to the new schedule. In the next migration wave, participants should be aware that the T2S day may not replicate current national practices.

An unintended consequence of the Hold and Release mechanism appears to be that many users are not releasing trades in to T2S until the last moment. This, in addition to the already described Auto Collateralisation and lack of partialling, caused a significant squeeze on liquidity.

Proposed action: We urge all parties to release their instructions to T2S as soon as possible in order to help avoid this issue.

Repo Impacts

When an open repo is terminated at the option of the buyer or seller or a fixed-term repo is terminated early, the confirmation/affirmation and settlement instructions for the close-out leg must include its transaction date.

Some parties have used the transaction date of the opening leg of the repo (as is best practice), but others, including in the Italian market, who book repos as separate transactions for reasons of operational simplicity, have used the transaction (trade) date of the close-out leg. As T2S makes the Trade Date a mandatory matching field the latter practice will cause unmatched trades in T2S where counterparties use the original transaction date. This is likely to have caused matching fails following the T2S go-live in Italy.

**Proposed Action:
Seek feedback from agents and the CSD on this, including Q4 data on efficiency / repair and conversion processes, to better quantify the perceived negative impacts.**

Parties using the latter practice who intend to settle across T2S will need to address this problem.

Ensure regular client reporting is enabled with the agent and bilateral discussions ensue with clients to agree conventions and practice on bookings.

Instructions could be provided to agents to match the trade date of incoming transactions which would no longer provide straight-through-processing (STP) but reduce the delay in processing with the additional workflow for approval and repair.

Association for Financial Markets in Europe

London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

www.afme.eu

Finally, although the best practice is to use the original trade date, for practical reasons, we recognise that counterparts will require flexibility especially late in the value date window to ensure timely settlement.

Conclusion

There were some key, positive messages that we believe it is important to record. Monte Titoli maintained a strong relationship with national and international investors alike. Frequent visits to their main clients were crucial to the success of the migration wave. From the CSD's perspective, they also recognised the importance of SSIs being well managed and populated throughout the custody chain and between the various accounts in T2S for their clients. Further action by all market participants and a single source held by future wave CSDs would improve settlement rates substantially.

AFME and ICMA believe that various lessons can be learned from the above analysis which will prove useful in preparation for the CSDs in the subsequent migration waves. This list is not exhaustive as other topics may have been found and resolved in the interim. AFME and ICMA would like to work in conjunction with local market associations where possible to ensure that their local CSDs understand the potential issues and have a plan to prevent them in their migration wave. To that end, we will seek confirmation that the entities referred to above understand the relevant issues and ask what steps have been taken to ensure no repetition.

The issues outlined above are, in the scope of the T2S project, relatively minor. The T2S team and the five CSDs that have migrated to date should be congratulated on their successful launch of this multi-year project. If the above actions are undertaken by the respective actors, including our members, we believe that future migration waves will benefit significantly.

Contacts:

Stephen Burton, Director, AFME Post Trade Division

Stephen.burton@afme.eu

Tel: +44 (0) 20 3828 2678

Alexander Westphal, Associate, ICMA

alexander.westphal@icmagroup.org

Tel +44 (0)20 7213 0333

Association for Financial Markets in Europe

London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700

Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971

www.afme.eu