State Street's Responses to HKEX T+1 Discussion Paper

Hong Kong's Settlement Cycle

Question 1

What do you think would be the effect of adopting a T+1 settlement cycle on the market vibrancy and competitiveness of the Hong Kong market as an international financial centre? Please give reasons for your views.

Based on international experience, adopting a T+1 settlement cycle would enhance market competitiveness and efficiency by reducing counterparty, market and liquidity risk, lowering margin requirements, and accelerating post-trade automation. These improvements translate into lower transaction costs and higher trading confidence which are key ingredients of a vibrant international financial centre. With major markets including US, Canada, India having already implemented T+1, while Europe, the UK and Switzerland plan to transition by Oct 2027, it's important for Hong Kong to maintain its competitive position with peer financial centres to align its settlement cycle.

However, the quality of execution matters: without careful transition planning (industry-wide testing, same-day affirmation discipline, and robust straight-through-processing (STP) metrics), compressed timelines (For Europe and US investors, it would effectively mean a T+0 operational environment) can initially increase settlement fails, raise funding frictions for cross-border investors (especially where FX still settles on longer cycles), and strain activities such as ETF processing and securities lending. These are manageable with clear standards and coordinated implementation, but they are real and should be anticipated.

In summary, it is our view that the key benefits of a move to T+1 in Hong Kong would include:

- Alignment with settlement cycle changes across other markets
- Potential improvement in STP
- Opportunity to modernize infrastructure
- Minimise counterparty risk

In terms of key drawbacks or challenges of such a move:

- Funding challenges for investors not based in the region
- Potential temporary increase in failed trades and buy in costs

Question 2

Do you see any effect in the implementation of T+1 on the long-term liquidity and risk management capabilities within the Hong Kong market, and in the harmonisation of the settlement cycle across major exchanges across global markets? Please give reasons for your views.

Implementing a T+1 settlement cycle in Hong Kong will, over the long term, enhance market liquidity and strengthen risk-management capabilities, while also advancing harmonisation with major global markets.

The direction of travel is consistent with the experience and analysis presented to the U.S. Securities and Exchange Commission and to ESMA on similar moves. The benefits depend on careful orchestration; without it, compressed timelines can pressure FX funding, ETF processing and securities lending, which could temporarily detract from liquidity until operating models adapt.

Liquidity and market quality: By shortening the settlement cycle, T+1 reduces counterparty, market and liquidity risk and lowers clearing margin and precautionary liquidity buffers. Over time, these reductions lower the cost of intermediation, a key factor in supporting the vibrancy of an international financial centre. The discipline required to allocate, confirm and affirm trades on trade date also improves straight-through processing (STP) and reduces post-trade breaks, further stabilising secondary-market liquidity.

Risk-management capabilities: The move to T+1 is a structural improvement in day-to-day risk control: exposures and liquidity needs are outstanding for fewer hours; operational risk declines as manual processes give way to automated workflows and same-day affirmation. Supervisory can entrench these gains by requiring written policies and procedures to achieve trade-date allocation/confirmation and by encouraging the publication of data by matching utilities on confirmation rates and timing. We note, however, that T+1 is not a cure-all for system-wide risk; broader market-structure issues lie outside the settlement cycle and should be addressed via other tools.

Shortening the settlement cycle - A Global view

Question 3
How has your organisation been involved in the recent T+1 transition in the US/ Americas and discussions in Europe?

T+1 in the US/ Americas

Industry collaboration was key to the successful implementation of T+1 in the US/ Americas. State Street actively participated in these discussions as member of SIFMA, ICI, and DTCC (the broker dealer/ fund management and custodian communities) to collectively identify issues, craft solution, define measures of success and shape timeframes as part of a high-level roadmap.

Some examples of initiatives include:

Engagement and Education among industry participants:

- Engagement, education and sharing of resources, such as the Implementation Playbook, detailed testing framework and library of materials maintained on DTCC-UST1.org site
- Regular industry readiness calls, client tabletops, educational webinar, panel discussion and client outreach throughout the lifecycle of the initiative.
- The T+1 Industry Command Center was established to ensure a smooth conversion by providing support prior to, during and post implementation, share conversion status information and increase transparency into participant activity. The Command Center also served as a central check point for issue identification and socialization and included various progress reports.

Client Outreach – Thought Leadership:

- Individual client meetings were scheduled by custody banks and other market participants prioritizing clients with low affirmation rates. This allowed us to drive client behaviour and encourage client-side operational readiness. Surveys were sent out to clients to assess their readiness and to identify set-up changes resulting from clients changing their affirmation models.
- Several thought leadership articles were published by us, and various Office Hours sessions were held with significant external participation.

<u>Discussions in UK/ Europe</u>

State Street actively participates in industry initiatives to shape the regulatory and operational frameworks for the advent of T+1 in UK/Europe:

- **UK**: State Street is a founding member of the **UK Accelerated Settlement Taskforce**, contributing to technical working groups and the upcoming Post-Trade Code of Conduct.
- **EU**: State Street is an active participant in **ESMA's technical workstreams**, including those on trading, matching, clearing, settlement, ETF, Corporate Actions and securities financing

Question 4
From your perspective, are there any learnings from the recent T+1 transition in the US/ Americas and discussions in Europe? Please give reasons for your views.

Learnings from T+1 in US/ Americas

There are several lessons learned from the transition to T+1 settlement in the US/ America that can help inform the efforts of the Hong Kong market.

1) **Overdrafts and Deposit Balances**

   State Street data (for the period from May 27–31 2024) indicates that average daily overdrafts and deposit balances remained consistent with business-as-usual (BAU) levels. There were no unusual spikes, nor did the move to T+1 introduce significant additional credit risk for State Street or its clients.

   - Existing liquidity frameworks and prudent risk management practices are sufficiently robust to weather the transition to a T+1 environment without significant disruption.
   - Market-wide fears about systemic liquidity risk due to T+1 were, at least in the initial phase, largely unfounded for major custodians like State Street.

2) **Settlement Fails Remain in Line with Normal Market Patterns**

   State Street data reveals that settlement fails across all impacted businesses during the transition week were in line with BAU levels. The underlying drivers for fails remained unchanged: brokers either being short shares or failing to deliver securities. Importantly, these fails were unrelated to the move to T+1.

   - T+1 did not materially worsen settlement fail rates for State Street and its counterparties.
   - The structural nature of settlement fails, centered around broker behavior and delivery issues, persisted independently of the settlement window.

3) **Significant Improvement in Affirmation Rates**

   Affirmation is the process by which trade details are agreed upon by both parties prior to settlement, a critical step in the US T+1 environment. State Street experienced significant progress in its affirmation rates, reaching 91% by May 31st, 2024, up from 80% in April. This improvement was the result of well-coordinated efforts on multiple fronts:

   - Engaging clients to increase the speed of instruction submissions and earlier trade affirmation.
   - Minimizing manual interventions by streamlining workflows and leveraging technology solutions for higher automation.

- Optimizing internal account structures and processing to reduce bottlenecks and expedite trade matching.

Targeted client outreach is essential for achieving high affirmation rates post-T+1. The active communication between State Street and its clients proved instrumental in incentivizing faster, more automated trade affirmation, which is crucial in a shortened settlement environment.

4) **Enhanced Liquidity and Reduced Settlement Risk Through Collateral Optimization**

One of the most tangible benefits of moving to T+1 was a material reduction in the amount of collateral required in the DTCC Clearing Fund. Returning these assets to market participants has had a notable impact:

- Firms have seen enhanced liquidity, as previously encumbered collateral is now available for other business or investment purposes.
- There has been a broad-based reduction in settlement risk across the participant base, as the speedier settlement window reduces the period of exposure for all parties involved.

The operational efficiencies introduced by T+1 can deliver immediate, quantifiable financial benefits.

5) **Industry-wide Collaboration and Change Management**

Industry-wide collaboration was a major factor in US/Americas' successful conversion to T+1 settlement. State Street's improvements in affirmation rates and maintenance of settlement efficiency were possible due to **close coordination with clients, brokers, and market infrastructure providers**. Change management strategies, including client education, early engagement, and investment in technology, were vital in overcoming the operational challenges of T+1.

Specific considerations for Hong Kong

Question 5
Do you have any views on the specific considerations laid out in the discussion paper for Hong Kong to consider in a transition to T+1?

One of the key factors that made the transition to T+1 a success in the US/Americas was close industry coordination through joint trade association/ industry forums. We encourage HKEX to consider establishing similar industry-wide collaboration and change management mechanisms to ensure timely identification of issues and to address potential solutions efficiently and effectively.

In addition, careful planning, an active testing protocol and appropriately lengthy transition period are also recommended.

Regarding the timing of implementing T+1 for Hong Kong, we would like to caution the scenario where by too many markets may try to move at once, thereby creating a resource challenge for the industry. We therefore encourage HKEX to remain in close dialogue with market participants on the timing decision.

In terms of our preferred model for T+1 in Hong Kong. It is our view that the settlement cycle should be standard across all asset types and for all investors. This should cover bond settling in CMU, stock connect and bond connect. (Note: CMU has different system and we would appreciate some clarifications if CMU will be in scope).

We would also like to highlight the special considerations below as being unique for Hong Kong to consider in the design of T+1 and its transition:

- Implement USM prior to T+1
- If Synapse becomes mandatory, this should happen before T+1
- Real time delivery versus payment (RDVP) model
- Early USD (And other settlement currency) cut off

Please see below our specific comments on Securities Lending.

Securities Lending

The proposed transition to a T+1 settlement cycle in the Hong Kong market presents notable challenges for securities lending. The current auto buy-in construct under CCASS introduces systemic constraints that may be exacerbated by the compressed timeline.

Key Risk Dimensions - These risks run counter to the initiative's stated goal of enhancing market efficiency and vibrancy.

- Settlement Risk: The shortened cycle increases the likelihood of settlement fails for securities on loan.
- Liquidity Risk: Lenders may reduce participation or retain greater inventory to manage settlement exposure, shrinking lending pools.
- Operational Risk: Operational complexity may deter market participants, undermining market vibrancy.

Strategic Recommendations - To mitigate the adverse impacts, the following options are proposed, grouped by feasibility and stakeholder involvement:

Short-Term Operational Adjustments

- Partial Settlement Flexibility - Allowing partial settlement of available inventory can reduce fail rates and associated costs, improving overall settlement probability.
- Easing Buy-In Penalties and Expanding Exemptions - Aligning with practices in regional markets such as Australia and Japan, where fails may roll without immediate action, could reduce punitive risk exposure and enhance resilience.

Medium-Term Infrastructure Enhancements

- Transition to Continuous Net Settlement (CNS) - Upgrading CCASS from batch processing to CNS could improve operational flexibility and reduce risk in stock lending and OTC movements.
- DLT-Based Trade flow Processing (e.g., SYNAPSE) - Leveraging distributed ledger technology for sale processing, recall issuance, and SBL review could streamline workflows. However, this would require significant investment from custodians and market participants.

Long-Term Policy Considerations

- Lender of Last Resort Mechanism - While unlikely given current HKEX priorities, a backstop facility could address systemic shortfalls.

To ensure a successful transition, we would recommend initiating a multi-stakeholder dialogue involving HKEX, custodians, and lending participants. A phased implementation approach, coupled with targeted infrastructure and policy enhancements, will be critical to balancing market vibrancy with operational resilience.

Question 6
Are there any considerations or issues related to a Hong Kong T+1 that are not included in the paper but which you would like to see included as part of the evaluation?

This paper has captured key considerations for a T+1 move. However, if there are specific operational nuances in the Hong Kong market that would require further discussion, industry forums can be set up to facilitate such discussions. As highlighted above, industry collaboration was key to the successful implementation of T+1 in the US/ Americas where State Street had actively participated in these discussions as member of SIFMA, ICI, and DTCC (the broker dealer/ fund management and custodian communities. Similarly, State Street can actively participate in the industry forums in Hong Kong to collectively identify issues, craft solution, define measures of success and shape timeframes as part of a high-level roadmap.