Migration to T+2 Settlement

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April 22, 2015

Agenda

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- Current Settlement Cycle
- Benefits of Shortening the Settlement Cycle
- Impact of Shortening the Settlement Cycle
- Challenges of Shortening the Settlement Cycle
- Operational Implications
- Timeline for Implementation
- Conclusion

Introduction

- **Trade Settlement Process Defined**
  - In financial markets **T+3** is a shorthand for **trade date plus three days** indicating when securities transactions must be settled. T+3 means that when a security is purchased, payment and the securities certificate must change hands no later than three business days after the trade is executed.
  - Example: Trade Date or T = Monday
    Day 1 = Tuesday
    Day 2 = Wednesday
    Day 3 or Settlement Date = Thursday

Introduction

- **Trade Settlement Process Historic Origins**
  - In the 1700s the Amsterdam and London stock exchanges had close ties and would often list each others stocks.
  - To clear the trades, time was required for the physical stock certificate or cash to move between Amsterdam to London.
  - Implementation of standard settlement period of 14 days which is the time it took for couriers to make the journey on horseback and by ship.
  - Same model used for the next couple hundred years.
  - Technological advances in the late 1970s and 1980s finally made it possible to reduce the settlement cycle to T+5 and then T+3 in 1995.

Introduction

- **Standard Settlement Cycles in the US**
  - Stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships traded on an exchange settle on T+3.
  - Government securities including US Treasury bonds, stock options, and options on futures contracts settle on the next business day following the trade, or T+1.
  - Foreign exchange often settles two days after trade date or T+2.
  - Futures contracts settle on the same day of the trade or T.
  - Many mutual fund trades currently settle on T+1.

Introduction

- **Global Trends**
  - Much of Europe adopted a T+2 settlement process effective October 6, 2014.
  - Many markets in Latin America and Asia including India, Hong Kong and Taiwan already adopted T+2 settlement practices.
  - Mexico reverted from T+2 to T+3 in 2006 to align with the US.
  - Canada and Chile align with the US and have agreed to change settlement cycles to conform with US standards
  - Many Eurasian countries use a pre-funding model for on-exchange trades and primarily settle T+0.
  - The Middle East region mostly operates using T+2 and T+3 cycles except for Saudi Arabia that uses a fully pre-funded model and settles T+0.

Current Settlement Cycle

- **Steps in the Trade Flow Process**
  - **Phase 1** – Trade execution
    - Includes confirmation of the details of the trade
  - **Phase 2** – Clearing
    - Computation of the obligations of the counterparties and communication to central securities depositories and custodians
  - **Phase 3** – Settlement
    - Updating of registrar records and cash movement

Current Settlement Cycle

- **Depository Trust & Clearing Corporation ("DTCC")**
  - The Central Securities Depository ("**CSD**") for the US
  - Largest CSD in the world
  - One of four ICSDs operating globally in over 130 countries
  - Through its subsidiary the National Securities Clearing Corporation ("**NSCC**") clears and settles the majority of securities transactions in the US

Current Settlement Cycle

- **Trade Date** – Trade details are electronically transmitted to NSCC for processing
  - Directly or indirectly through a correspondent relationship.
- **T+1** – NSCC's guarantee of settlement generally begins midnight between T+1 and T+2
  - NSCC is the counterparty eliminating settlement uncertainty.
- **T+2** – NSCC issues summaries of all compared or cleared trades
- **T+3** – Settlement occurs

Benefits of Shorter Settlement Cycles

- **Reducing Market Risk** – the longer the position remains open, the greater risk associated with closing it out
- **Reducing Participant Exposure to NSCC** – The exposure could be reduced by 25% for each day the settlement cycle is reduced from the current T+3 scenario
- **Reducing CCP Liquidity Needs** – NSCC maintains liquidity resources to effect settlement should there be a default and shortening the settlement cycle will reduce the required coverage
- **Reducing Systemic Risk** – The lag time between trade date and settlement date creates exposure

Impact of Shorter Settlement Cycles

- **Primarily impacts asset managers, custodians and other institutional business**
  - Retail firms already require cash prefunding and discourage physical securities.
- **Acceleration of current timeframes and cutoffs**
- **Technological enhancements**
- **DTCC enhancements/changes**
  - Dematerialization
  - Reduction in the limits for automatic securities transaction processing (Receiver Authorized Delivery)
  - Match to Settlement

Challenges of Shorter Settlement Cycles

- Forces trade comparison, reporting and allocation earlier on Trade Days to avoid increased fails, risk and cost
- Requires DVP/RVP end-to-end process redesign (central matching, leverage obligation warehouse)
- Technological enhancements including:
  - Near real-time compare/affirm near execution time
  - STP for allocations
- Ex-clearing and non DTCC eligible securities must leverage CDS capabilities
- Fail Controls must be robust

Challenges of Shorter Settlement Cycles

Continued:

- Managing cash availability for settlement
- Requirement for prefunding especially retail customers
- Capacity concerns due to compression of processes
- Implementation costs especially for small to mid-size firms

Operational Implications

Accelerate activities to deal with exceptions throughout the trade day:

- Real time trade submission
- Possible late shift to resolve trade breaks
- Trade affirmation prior to midnight on trade days
- Trade allocations
- FX processing is currently not the same day
- Fail Control
- Lack of harmony with other countries
- ACH payout timelines

Operational Implications

Resolve industry and firm requirements:

- Physical securities
- Trade matching centralization and redesign
- Banks utilizing ACATS
- Avoid or mitigate potential cost increase
- Enforce existing standards

Challenges of T+1 Settlement

- Limitation in existing market infrastructure
- Pressure on back office function of buy side
- Payment system and client funding bottlenecks
- Foreign exchange transaction for cross border trades
- Technological limitations

Timeline for Implementation

- No set date yet
- Discussions include a multi-year implementation timeframe
- Industry and regulators holding meeting to discuss issues and concerns
- Endorsement by DTCC and various trade associations including SIMFA and ICI

Additional Resources

- Target 2 Settlement (http://www.ust2.com/)
- Position Paper: **DTCC Recommends Shortening the Settlement Cycle** (http://www.dtcc.com/~/media/Files/Downloads/WhitePapers/t2-Shortened-Cycle-WP.pdf)
- White Paper: **Cost Benefit Analysis of Shortening the Settlement Cycle** (http://www.dtcc.com/~/media/Files/Downloads/WhitePapers/CBA_BCG_Shortening_the_Settlement_Cycle_October2012.pdf)

Conclusion

- T+2 Settlement is coming in the not too distant future
- The benefits include reduced market and systemic risks and liquidity needs
- Technological and operational challenges need to be addressed

Questions