No day after tomorrow. 2.0

DTCC shortens the settlement cycle from T+2 to T+1

(Incl. client survey)

NEXGEN

NEXGEN Whitepaper
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Introduction

We were able to provide new insights on the topic of T+1 as early as August 2022 with our first whitepaper.

In our whitepaper we described among other things:

- Expected improvements
- Risks and hurdles of the planned transition
- Effects on the settlement process
- And why not switch to T+0 right away.

On this basis, and as the transition to T+1 has gained further momentum thanks to the SEC's recent release, we aim to dive even further into the topic with our second whitepaper. To this end, in addition to new market information and the expertise of NEXGEN, we also draw on the expert knowledge of affected market participants.

In advance to our second whitepaper, we conducted a market survey on the topic of T+1 settlement. Participants included asset managers, custodians, CSDs, as well as universal banks, that are affected in various ways by the transition of the U.S. standard settlement cycle to T+1. The feedback from respondents provided us with detailed information on the areas identified as impacted. Furthermore, we were also able to gain an understanding of whether T+1 is already on the agenda of relevant companies.

If you are also interested in an initial exchange on this topic, you will find the contact persons on the last page of this whitepaper.

What´s new?

After a long consultation and discussion phase, on 15.02.2023 SEC officially confirmed the implementation of the T+1 shortened settlement cycle. The go-live date is now set for 28.05.2024, and from this point on equities, corporate bonds and fund shares in the U.S. market will settle according to the shortened cycle.

Final regulations also intend to improve the settlement of institutional trading participants' trades. This will require Broker-Dealers to either enter into written agreements or establish, maintain and enforce written policies and procedures. These should be designed in a reasonable matter ensuring the completion of allocations, confirmations and affirmations as soon as technologically practicable but no later than the end of the trading day.

Evaluation of the market survey

Latest since the publication of the AFME whitepaper, which appeared a few weeks after our first whitepaper on T+1, the topic has become well known in Europe too. As a matter of fact, this is also reflected in the results of our market survey, in which all participants stated that they had already heard about the concept.

Another question to which all participants answered "yes" was the inquiry about the existence of trading and settlement activities in the US. This result once again illustrates the relevance of the topic, also for European market participants.

However, we received varying responses to the question whether analyses have already been undertaken to adapt to the shortened settlement cycle. Just under half of the participants looked at the issue in more detail so far, even though test phases in the U.S. have been underway for a considerable time period.

Nevertheless, all respondents named business segments or topics that they felt would be most affected by the changes. We present the most frequently mentioned points in the following table.

The surveyed participants see the following items as having the greatest impact:

Requirements of market infrastructure providers	In order to meet the requirements for implementing the T+1 settlement in the U.S. market, definition of clear requisites is needed by the CSDs and sub-custodians. This will lay the foundation for uniform reconciliation along the entire value chain.
Contractual adjustments	The implementation of T+1 requires process adjustments, both internally and for external suppliers. This includes among others a redesign of cut-off times and the start time of batch runs.
Adaptations to organizational set-ups	The reduction of the settlement cycle by 50% in combination with the time difference between various markets will most likely result in adjustments to the working time model for individual employees. Some of the survey respondents point out that introducing shift systems may be necessary.
Increase in STP rate	Inevitably, when the settlement cycle is halved, the STP rate must be optimized. In addition to the communication taking place as standardized as possible via SWIFT, automated processing is also imperative. One point frequently mentioned in this context was the improvement of SSIs.
Fails Management (Exception Handling)	For manual processes, such as fails management, new staff may need to be hired for a more intensive nighttime processing. It would make sense to coordinate with other market participants and establish automated and standardized communication to the furthest extent possible. One idea of a customer we interviewed was to design the communication as simple as possible via a GUI.

In order to clarify the above-mentioned points and adopt a targeted approach, all participants in the survey would like to see active support at the association level to thereby obtain clear guidelines for implementation between the various market participants.

In addition to the above listed items, further issues were identified that affect market actors, regardless of their volume of trade and settlement activity in the United States.

Due to the general relevance of these problems, they will be described in more detail in the following chapter.

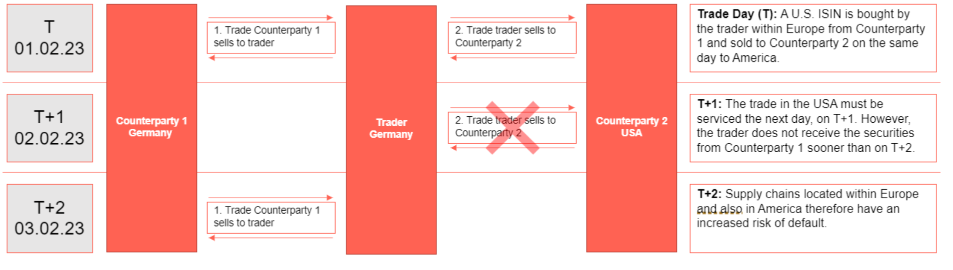
Trade between T+1 and T+2 markets

Due to the rapidly approaching transition to T+1 in the U.S. (and also in Canada), settlement discrepancies between markets that continue to settle on a T+2 basis and the markets mentioned earlier emerge. As a result, problems arise particularly in relation to linked transactions.

Linked transactions include liquidity procurement for trades in foreign currencies, sales of securities that are recalled from securities lending as part of today's recall process, or supply chain transactions.

For these trades, differences between T+2 and T+1 markets can lead to settlement fails for the involved parties.

Since these issues were also identified as problematic by some of our survey respondents, they are illustrated below with two concrete examples:



1) Problem with supply chains between T+2 and T+1 markets

Today, it is common practice to buy securities from a counterparty or recall them from securities lending and then resell them directly to another counterparty. This practice is often referred to as a supply chain transaction.

In the future such cross-market transactions will only be possible to a limited extent:

Assuming a trader buys securities from Counterparty 1 in the German market, as shown in the chart above, and then wants to sell them directly to Counterparty 2 in the U.S. market, the different settlement cycles lead to serious settlement problems.

The delivery of the first trade by Counterparty 1 takes place on T+2, according to the settlement standard of the German market. However, the trader must deliver the securities to his Counterparty 2 in the American market on T+1. A gap of one day is therefore created, as the securities must be delivered on the American market before they have even been received on the German market. This leads to a settlement fail on the side of the trader.

2) Liquidity procurement for trading transactions in foreign currencies

Today FX spot markets operate based on a T+2 settlement cycle. When trading securities in a market that also operates according to T+2, one can stock up on the required foreign trading currency on time, in accordance with the outstanding transactions.

However, there could be problems in the future, for example when buying securities on the U.S. market. In this case, liquidity must be available already on T+1 so that the purchase transactions can be settled. Targeted covering with cash after the trade on a T+2 market will no longer be possible.

Therefore better advance planning is needed:

In a T+2 environment, the timely procurement of liquidity in the respective currency can be ensured for trades in foreign currencies even after the conclusion of a securities trade, as long as the stocking up takes place on the same day before the close of trading. Since the FX spot markets also follow a standard settlement cycle of T+2, sufficient liquidity should be available on the security trade’s day of settlement, so on T+2.

Further important remarks

In the future, however, the discrepancy between T+2 and T+1 must also be taken into account in liquidity management:

For example, if a German trader trading in EUR wants to buy U.S. dollar-denominated securities in the USA at any time, he must plan his liquidity further in advance. Since any securities business carried out there should be settled on T+1, it is not possible to provide sufficient liquidity only on the trade date. In the case of a T+2 settlement, this would be available too late for the settlement of the security transaction. Consequently, internal processes must be adapted to ensure sufficient liquidity.

In order to avoid problems of this sort when trading between markets with different standard settlement cycles, introducing a shortening to T+1 is also a possible solution in Europe. In our survey we also asked participants whether such a solution would indeed be desirable.

In principle, a switch to T+1 in Europe is seen as positive.

When asked to what extent this would be a logical development for the European market, our respondents answered almost unanimously. The majority of participants in our survey see a clear added value in a shortened settlement cycle. 20% of the respondents even went as far as to describe the current business processing as "no longer up to date".

However, in case a T+1 project is not optimally planned in Europe, some of the clients interviewed particularly see their settlement efficiency at risk and expect higher CSDR penalties as a result. Nonetheless, they also believe that in the long run T+1 is certainly a step in the right direction for the European market.

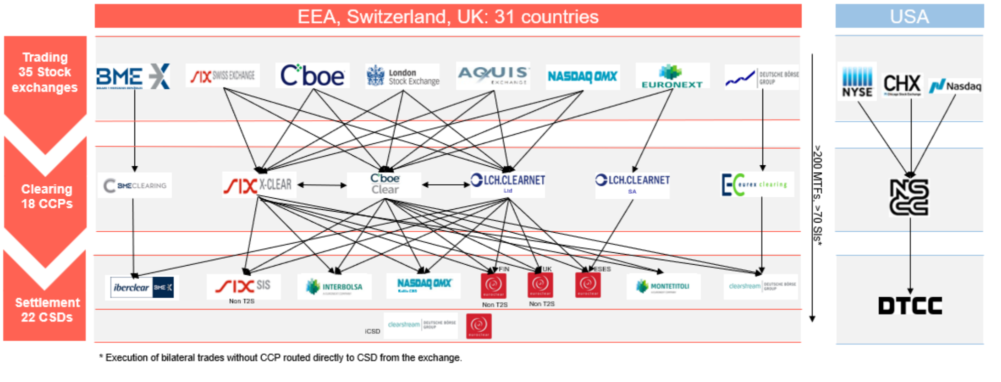
T+1 IN EUROPE

As already indicated, a T+1 implementation in Europe is not easy to execute. It is not only the complex structure of the European trade and post-trade market infrastructure that has to be taken into account, but also the 14 distinct currencies and the differences in the legislation of the individual countries.

Background

The European trade landscape comprises 31 countries with 35 different exchanges, 18 CCPs and 22 CSDs*. In addition, almost every European country has its own CSD; the only exceptions are the two ICSDs Clearstream International and Euroclear Bank. A certain kind of consolidation at the CCP level can be observed at most with SIX, LCH and Cboe Clear Europe, as these providers enable clearing across different exchanges and CSDs and are also interoperable with each other. This fragmented division of the European market therefore does not allow for a direct comparison with the market infrastructure in the U.S.

While in the U.S. only 3 major exchanges are operated, the biggest difference to Europe is perceived in the post-trade environment. Here, all clearing and settlement activities are carried out through the jointly owned DTCC. Thus, a single CCP and a CSD serve the entire American market.



Trade environment: Europe and USA

*Status as of end of 2019 according to *AFME: T+1 Settlement in Europe: Potential Benefits and Challenges (2022)*

State of current discussion

In the U.S. the T+1 Working Group Series set up by DTCC has been running since April 2022 with the goal of actively informing market participants about the approach taken to switch to T+1.

T+1 is now also receiving more and more attention in Europe. Recently, there have been initial roundtables and publications addressing the impact of the T+1 transition on European markets. In its whitepaper, AFME advocates a review of existing regulations and best practices and calls for companies to conduct an initial front-to-back impact analysis. First and foremost, all barriers need to be clearly understood before moving to T+1. With this goal in mind, both the UK and AFME have announced the establishment of an "Industry Taskforce" to address the most relevant issues.

Initial proposals in Europe promote the improvement of operative processes with a focus on automation and harmonization:	
• Revision of outdated technologies	• Enabling matching on Trade Day
• Moving away from batch processing and instead using APIs to exchange data in real time	• Intensified use of partial settlement to avoid settlement failures
• Dematerialization of all securities and promotion of electronic records via central securities depositories in order to execute settlements faster	• Extension of operating hours and adjustments to settlement cycles for CSDs, possible shortening of the trading day
• Adjustments to the CSDR Settlement Discipline regime	

The initiative to unify the various European post-trade landscapes will by no means end with the change to T+1.

With the use of blockchain/DLT, even instant settlement (T+0) would be possible, as automated settlement of mutual obligations at the technical level can be executed in real time (DvP or DvD). In order to drive this development, the regulator has created the DLT Pilot Regime, a sandbox that allows market participants to test the handling of such technologies using digital finance and motivate them to shape future legislation in this area. We will address this topic in the next whitepaper of our T+1 series.

Interested in more information?

Would you like to know if and which processes exactly need to be adapted or optimized in your institute to meet the requirements of the shortened settlement cycle?

Are you wondering which levers you can pull to create the biggest impact and where you currently stand compared to other firms in your industry?

Or are you interested in general questions concerning the T+1 settlement and the securities settlement processes? Would you like to find out how you can further improve in this field?

We look forward to hearing from you to discuss your individual questions and requests.

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