A T+1 Forum Paper

ISITC
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Accelerated Settlement - Global Trend, Local Challenges

GUIDE TO AREAS IMPACTED AND RECOMMENDATIONS TO AID A SUCCESSFUL TRANSITION TO T+1

ISITC Europe CIC

Contents

Recommendations

- Don't wait for the UK Task Force, ESMA or any other regulatory body, start your analysis NOW of the impact of T+1 settlement on: Your business, systems, processes, employees, and clients.
- Eliminate manual procedures and paper driven processes.
- Analyse data architecture and technology and streamline access/ management capabilities to enable effective data management in near real-time.
- Address the use of batch processing and move to real-time processing.
- All buy-side firms need to use electronic trade matching/confirmation/allocation systems.
- All firms to analyse collateral management impacts and existing treasury functions or establish new, to cater for prefunding and managing market risk on behalf of clients.
- Fund managers should investigate the impact on ETFs for their business and clients and if necessary, make contractual changes.
- All Firms should set budgets (for at least 2-3 years) to instigate projects to ensure systems and procedures can operate in a real-time environment.
- Begin legacy system replacement with immediate effect and innovate solutions.
- Talk to clients and settlement agents in preparation for T+1.
- There should be co-ordination between Global CSDs and ICSDs to help reduce potential settlement fails and they should extend direct access to all buy-side firms.
- A cost benefit analysis should be undertaken/published, covering all market participants.

Introduction

ISITC Europe was commissioned by the Swift Institute in 2022 to conduct research into the global impact of shortening the securities settlement cycle to T+1 or even T0. The driving force at the time was an announcement made on 28th April 2021 that the Securities Industry and Financial Markets Association (SIFMA), The Investment Company Institute (ICI), and The Depository Trust & Clearing Corporation (DTCC) were collaborating to accelerate the U.S. securities settlement cycle from T+2 (two business days after a trade is executed) to T+1 to bring about greater efficiencies and reduce trapped liquidity. Subsequently, the SEC announced on the 15th of February 2023 an implementation date for the North American move to T+1 settlement.

The decision by North America to accelerate to a T+1 cycle greatly reduces the time available to settle a securities trade in one of the most important global markets. One which significantly dominates portfolio investing not only in North America, but the also the rest of the world. It is important therefore to explore how this move by North America will impact various areas of operations within both buy and sell-side firms and business globally and look at potential solutions.

This paper draws on the extensive research conducted throughout the course of 2022/23 by way of in-depth interviews and focus group workshops with key stakeholders in the financial industry, as outlined in the academic research paper ‘Industry preparedness for accelerated settlement’[i] It provides an overview of the issues surrounding accelerated settlement and offers insights for industry practitioners.

The findings in this paper are based on the research study, industry expertise and further ongoing analysis to:

1. Help focus the industry on the key issues which need to be addressed.
    a. Timeframe
    b. Operational Issues
    c. Global co-ordination
    d. Regulatory approach
    e. Cost
2. Help stakeholders identify gaps in their current settlement processes and develop strategies to meet the demands of accelerated settlement.

ISITC Europe will continue to explore solutions to some of the issues outlined in this paper, throughout 2023/24 hosted by EY in London, through a series of cross-market roundtable discussions in collaboration with the CISI, IA and PIMFA to ensure representation of buy-side interests, details of which can be found on the ISITC Europe website.

Timeframe

> *Don't wait for the UK Task Force. ESMA or any other regulatory body, start your analysis NOW of the impact of T+1 Settlement on:*
>
> 1. *Your business*
> 2. *Your systems*
> 3. *Your processes*
> 4. *Your employees*
> 5. *Your clients*

The US timetable is extremely challenging even for US firms and doesn't allow time to properly address the issues, especially for overseas investors. Who according to the US Treasury [1]invested a sizable 24,893 billion dollars as of the year end of June 2022.

Operational Issues

Technology

Technology is not seen as a major barrier to T+1 for domestic settlement, providing the assets and cash are digital and within the central securities depository (CSD). Firms that do not have direct access to a CSD and rely on an agent or custodian will need to address how they can provide accurate and timely settlement information without the need for paper fax or email confirmations.

The introduction of new technology and systems within a year and on a global industry-wide scale is extremely unlikely. Rather existing technology will need to be adapted before any investment in system replacements or new technology. Lessons have been learned recently of how disastrous it can be for a market to rush into implementing new technology. So, a more cautious approach to DLT, AI and the like, has been instigated with the introduction of the EUs DLT Pilot Regime and the UKs FCA Sandbox, with most firms still exploring the practicality and cost of how and where these can be introduced. However, these technologies will inevitably be implemented at some point.

Firms mainly on the buy-side are likely to carry the technology investment burden. First however they need to assess their requirements and potential solutions. Procure and test them, before implementation and live running. This is a major task for the industry. Unfortunately, there is no domestic or international central organisation to drive the plan for this wholesale industry change.

Data

Of all the challenges brought by T+1, data is the most long standing and most understood, but is the most difficult to resolve. The tendency is to look at data solutions as either technology or standards. Both are true and both have attained improvements over decades. Yet the quality of data from an industry settlement supply chain perspective continues to be a cause of settlement failure. Accelerating settlement will force further attention on solving the data quality issue.

Standard Settlement Instructions (SSI) have been a major area that needs across industry attention as after many years there are still errors appearing across different databases of the players in the settlement eco system. OMGEO made some positive impacts in its early years before being absorbed by the DTCC. Today, there

[1] https://home.treasury.gov/system/files/136/shl2022_report.pdf

is a startup firm SSImple, which is offering a solution, whether this will extend to a global offering remains to be seen.

Competing SSI service suppliers can also cause difficulties. A non-commercial entity or industry cooperative might be the answer.

Central databases (or alternatively DLT) with secure access and auditability of data changes could be a solution. It is likely that the industry will be faced with a choice of multiple solutions, so interoperability will be a necessity. Recently, there has been a step forward with two organisations Swift and R3 announcing successful projects achieving blockchain interoperability.

1. *Eliminate Manual Procedures and paper driven processes.*
2. *Analyse data architecture and technology*
3. *Streamline access/ management capabilities to enable effective data management in near real-time.*

Batch Processing

Multiple batch processing is often used to simulate real-time and is operated by many firms including most custodians. Whilst the use of batch processing is declining, most organisations commented during the research that even where the firm itself has worked hard to remove this speed restriction in their systems, it still prevalent within the settlement chain.

Therefore, batch processing, which is intrinsic to the market globally, presents a real problem. Especially, as the DTCC (who operate batch processing) has stipulated a cut off time of 9pm EDT for the new T+1 settlement cycle. This means that data within the batch must be 100% accurate on trade date, if the transaction is to be settled the following day. This will make it virtually impossible for batches emanating from Europe or Asia to be clear of errors, given that exceptions will occur outside of regular business hours. Logic dictates the likelihood of an increase in failed settlements from the international markets.

Address the use of batch processing and move to real-time processing.

Electronic Trade Matching/Confirmation/Affirmation Systems

A significant number of firms and their transactions that do not use any of the available electronic trade conformation systems. Even in the USA, trade date matching/confirmations/affirmations is below 70%. Worldwide the picture is even worse! There is still a worrying lack of standards in this important function despite solutions being available for decades.

Firms, but especially buy-side investing firms, will need to improve their use of established electronic trade matching/confirmation/allocation systems available in the market today, to be able to achieve the very tight deadlines associated with accelerated settlement processes.

All buy-side firms need to use electronic trade matching/confirmation/allocation systems.

Reconciliations

Reconciliations only came to the fore during the analysis phase of the research but clearly end of day reconciliations on settlement date will be too late to improve settlement efficiency.

There is the potential that unreconciled positions will be put forward to settle and this will increase fails.

Firms will also need to assess the potential for theft or fraud if reconciliations are carried out after settlement and put in place the necessary controls and procedures to mitigate this risk.

Foreign Exchange (FX)

FX will be a major problem for international investors. The time zone differences plus the standard T+2 settlement for FX will create a prefunding cost and market risk.

The time difference between the settlement of the equity transaction with the FX trade will also create a funding issue.

Firms that currently operate a treasury business and provide their own FX executions across the office will be best placed to provide best execution. However, there are many firms that outsource the FX execution to their agent or Custodian.

The research and current intel have found that there is no intention by the FX markets to move to T+1. Some firms have stated that ad hoc arrangements for T+1 settlement is currently available, but at an increased cost.

It is unclear whether if the FX market does eventually move to T+1 the spread will increase.

Firms will need to determine how they will operate their treasury operations either by establishing one or putting in place a treasury operation using agents that provide best execution along the lines of CLS.

All firms to analyse collateral management impacts and existing treasury functions or establish new, to cater for prefunding and managing market risk on behalf of clients.

Stock Borrowing /Lending

The need to increase liquidity in the market has been presented as a benefit of T+1. Automated stock borrowing and lending by Custodians is seen as a business opportunity and could help settlement efficiency. However, this only applies to the most liquid stocks. For less traded illiquid stocks, new listings, stock borrowing is vital for settlement, or when a market short prevails.

It is clear that call-back operations, where lent stock must be recalled to settle a trade, will be much more challenging. Especially in a market where operations are not always standardised. This issue will be a factor for lenders in the market and for their agents.

Research has shown that some lenders already concerned by stock recall in T+1 may consider withdrawal, due to the economic benefits being eroded with a shorter settlement cycle and operational costs increasing. It is a very small margin business and it's possible that borrowing stock costs will have to increase to retain this essential service.

Buy-Ins

There has been a concern expressed that if settlement fails increase, or if stock lenders withdraw from the market, there will be an increase in the buy-in of shares. The market push back on the requirement for automatic buy-ins contained in the CSDR regulation might now actually be necessary to motivate settlement efficiency.

Asset Servicing

It was not clear if there will be a direct impact on asset servicing, bar the possibility of the narrowing of the ex-date and books close date. Any reduction of time between the record date and ex-date will likely increase market claims if there is an increase in settlement fails.

Issuers

Issuers will benefit from receiving faster payments, but conversely, they will have to pay out earlier too.

ETFs

Exchange Traded Funds (ETFs) appear to not have been considered when North America made the decision to move to T+1. This has been concluded because there has been no specific mention of how redemptions of mixed international ETFs will be handled. Clearly North America settling a percentage of an ETF on T+1, if the balance is settling on T+2 or even T+3+. is likely to result in increased market risk, collateral, and funding for investors. This cost will need to be factored into the price in the market.

Currently, there appears to be no technology or operational solution to solve the increased cost of funding. There Is a possibility that this may lead to some international ETFs excluding securities from North America. Similarly, it could lead to ETFs specific to the UK or the EU. Unlikely as it looks today if differences in jurisdictions increase costs to investors this might happen!

ETFs are one of the most attractive financial products in the capital markets with popularity growing year on year. A solution needs to be found or risk reducing the attraction by investors of an important product.

Fund managers should investigate the impact on ETFs for their business and clients and if necessary, make contractual changes.

Investors

Research has found that the only investor benefit identified by the market was a faster receipt of funds and the possibility of quicker reinvestment, for sell transactions. Of course, the opposite is true for purchases, where funds will be released from the client account faster.

Traders

Trading will benefit from T+1 with faster turnround of buying and selling. However, if the trader is operating within a nominee supported account, they already have this benefit.

Payment Banks

T+1 could increase payments throughout the industry. Increased buying and selling by traders would imply an increase in payment messages. However, it's not clear at this stage if payment banks will increase their charges accordingly.

Overnight Accounts

More trading on a faster turnround internationally, creating more FX and potentially more funding because of the settlement disparity between the stock and the FX may require traders or investors to not leave as much money on overnight deposit. This might be an unintended consequence that will need further research.

Regulatory Approach

It is market convention that sell side firms protected their counterparties/investors from extra costs, all in the name of protecting the business relationship. Therefore, the costs of inefficiency have been hidden by the sell-side, and occasionally the buy-side if the investor is big enough.

It has been decades since the London Stock Exchange presented reports of failed settlements and penalties for poor performance. Today the only penalty for failed settlements is a buy-in and this is as a last resort.

It has been stated by some firms that under T+1 they will not deal with inefficient clients. However, when pressed, the clients referred to were the smaller ones. In reality, large clients that provide the firm and its traders with annual high commissions and trading volume, will not see any penalties for any failures.

Unfortunately, the lack of transparency regarding failed settlements and why they fail, provides a cloak for inefficiencies. A transparent approach is required to motivate bad settling firms and clients no matter how powerful to improve settlement efficiency.

There has been little presented concerning how failed settlements will be penalised or if they will? Who will issue the penalty? Regulator or Sell side firm? What basis the penalty would be calculated? What would be the appeals process and who benefits from any financial penalty? More needs to be presented to the market about how any penalties will work, to motivate firms to resolve any failings in their business systems or processes.

Global Co-Ordination

When Europe moved from T+3 to T+2 it hardly caused a ripple in North America even though it remained at T+3, because firms still had enough time to settle and correct any errors. Similarly, in Europe the move from T+3 to T+2 was relatively easy, as T+2 allowed for error correction.

However, due to the time zone difference, this is not the case with North America's unilateral decision to move to T+1 ahead of the UK, Europe, and various markets in Asia Pac. Taking one day out of the settlement process means that there is no time buffer to allow for correction of errors. These now must be performed on Trade Date.

What is required to allow at least the same level of settlement performance that is being achieved today is co-ordination between global CSDs and ICSDs. Ironically, all these organisations, including the DTCC who has been at the forefront of the move to T+1 operate batch, rather than real-time processing.

Co-ordination between the DTCC and Euroclear for example might extend the cut off time in North America by a few hours, allowing international markets a tad more time to correct errors. Even scheduling multi batches between CSDs, for example every hour would greatly reduce the potential settlement fails.

There should be co-ordination between Global CSDs and ICSDs to aid in the reduction of settlement fails.

Cost

In 2012 the estimated overall cost of moving to T+1 in North America was given as $1,770M[ii] compared with $550M for the move to T+2. The investment needed was broken down as:

Institutional Broker/Dealer	Up to $20M large players - Up to $12M medium - Up to $4.5M small
Retail Broker/Dealer	Up to $15M for large players - Up to $7M medium – Up to $3M small
Buy-side	Up to $2M for large players – Up to $1.5M medium – Up to $600k small.
Custodian Banks	Up to $16.5M for large players – Up to 12M medium – Up to $1M small
Others	Investments vary by type of player.

Currently, there appears to have been no estimation of the overall cost of the move to T+1, either in North America or elsewhere, but market intelligence suggests that although some improvements have been made to systems and processes since then, the cost today could be significantly more.

In comparison, in the 2012 cost benefit analysis, the overall Ops Cost benefit of moving to T+1 in North America was given as ~$175M compared with the move to T+2 ~$170M. The main beneficiaries of the extra ~$5M being the Institutional Broker/Dealers, whilst the other players received the same benefit, whether settling on T+1 or T+2.

The conclusion of 2012 report being that whilst there was an appetite and beneficial returns over a relatively short timeframe for North America to move to T+2, especially as other markets were already operating or about to move to a T+2 environment, a move to T+1 was considered undesirable at the time. Unfortunately, many of the key impediments, which made the move to T+1 more difficult and were highlighted in the report remain today.

A cost benefit analysis should be undertaken and published, covering all market participants.

Industry Preparedness

At the beginning of the research there were a high number of non-US based SME firms that were unaware of the move from T+2 to T+1 settlement in North America and what its impact would be on their business and systems. Only a few firms had assigned a budget or resources to investigate and plan for T+1.

As the research continued, knowledge of the move to accelerate to T+1 became more widespread, especially once the North American regulators confirmed their plans and announced an implementation date. The UK and Europe announced initiatives to look at potentially following North America. However, as the formal date announcement was not made until early 2023, most budgets for 2023 and in many cases 2024 have already been assigned.

The lack of early resources being put into T+1 projects could greatly impact firms' ability to properly prepare for the North American very tight deadline of May 2024. This situation must change to avoid international markets suffering an increase in failed settlements, costs, and risks over an extended period.

The UK Accelerated task force is due to publish its findings and recommendations at the end of 2023. There have been indications that the UK will wait and see the results of the North American experience before announcing a date or timescale for implementation of T+1 in the UK. This indicates there will be a period of several years where the UK will be out of sync with North America.

The EU appear to be following a similar path, but with significant challenges through legislation and political decision making that may take several years more than the UK. Thus, the immediate future looks somewhat turbulent with regards to international settlement.

Since the publication of the research report there has generally been an increase in global market awareness, especially on the sell side, but the buyside still lags worryingly behind. Some UK buyside firms have said that they will wait for the UK's Accelerated Settlement Task force to announce a date for implementation. The EU markets are similarly waiting on ESMA. Meanwhile the May 28th, 2024, implementation date gets closer.

It is clear that the market as a whole, but predominantly the buyside needs direction and leadership, to understand what they need to invest in and when. They also need to be measured in terms of their preparation. This will probably require regulatory involvement along with Government legislation as without enforcement the road to T+1 looks painful and expensive.

Market Resilience

Concerns have been raised about increased operational risk in a T+1 environment. Today, under the T+2 protocol, there is the extra day to resolve any technical issues, (whether internal or external) which may occur, however with T+1 that day is lost and the resulting impact on settlement in the market will be amplified.

Another obvious concern when the markets are operating in a near real-time, would be the impact of a cybersecurity attack.

1. All Firms should instigate projects to ensure systems and procedures can operate in a real-time environment.
2. Begin legacy system replacement with immediate effect.
3. Talk to clients and settlement agents in preparation for T+1.

Conclusion

It is understood that T+1 settlement will bring enormous benefits in terms of collateral, margin, and risk reductions for the industry. However, there are concerns from the buy-side of the industry that these benefits will not be passed on by the sell-side. Many buy-side firms are apprehensive that they will see increased costs and a large increase in operational risks.

Nevertheless, accelerated settlement does bring some less measurable benefits and generates a powerful argument to drive change, improving market inefficiencies for the benefit of investors through the necessity of increasing automation and straight through processing.

However, implementing T+1 in a very short deadline could temporarily negate some of these benefits, as some firms will struggle to deliver all the process improvements, they will need to put in place to effectively operate in a T+1 environment, especially when investing into markets with difficult to manage time zone challenges.

There is also a fear of market disruption if settlement fails increase. The introduction of new technology solutions on an industry-wide international scale could take much more time than has been allotted.

This is an important change for the world's capital markets and must be introduced without disruption to the markets or investors and where costs and benefits are more equally shared. T+1 and even T+0 is entirely possible and eminently desirable. However, the timescale set is unlikely to achieve the hoped for outcome and will likely leave firms behind and investors picking up the costs.

Acknowledgements

The ISITC Europe research team would like to extend its grateful thanks to all the people and associations around the world, who gave of their time and expertise to participate in this research. In particular to Professor Daniel Broby and Professor Mark Durkin at Ulster University Business School for their input into and peer review of the academic report Industry preparedness for accelerated settlement. To Simon Daniel at Swift who hosted the T+1 workshop in London and Richard Leigh at the SIO (Scottish Investment Operations) who organised and hosted the workshop in Edinburgh. To Kevin Sloane and Mike Cahill at PIMFA who galvanised their members into taking part and of course to all the people at the SWIFT Institute, especially Nancy Murphy and her team who commissioned the research and Whikie Lui who facilitated introductions to additional participants in the Asia-Pac region.

About ISITC Europe CIC

ISITC Europe CIC is a not-for-profit, Community Interest Company. ISITC Europe is an industry body and a catalyst for collaborative innovation within the Capital Markets. What makes us different? We facilitate a community that represents all operational functions from firms, that span the entire Capital Markets ecosystem from Issuers through to Investors and Academia. So that we can deliver value by working collectively to address the trends, challenges and opportunities impacting the industry. ISITC Europe provides a platform for knowledge sharing and collaboration through a variety of activities, covering some of the most pressing challenges and opportunities facing the industry.

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[i] Gandy, Anthony and Broby, Daniel and Wright, Gary and Freeman, Tony and Durkin, Mark, Industry Preparedness for Accelerated Settlement (May 30, 2023). SWIFT Institute Working Paper No. 2022-003 (May 2023), available at: https://swiftinstitute.org/wp-content/uploads/2023/05/SIWP-2022-003-Industry-preparedness-for-accelerated-settlement_vfinal.pdf or https://isitc-europe.com/industry-preparedness-for-accelerated-settlement-report/

[ii] Source: BCG