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Migration to T+2 Settlement

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Overview of T+2 Settlement

The late J. Carter Beese Jr., former SEC commissioner, gave a speech in 1993 where he famously said, “Nothing good ever happens to a trade between trade date and settlement date.” His remarks were meant to encourage the industry to shorten the existing T+5 settlement cycle to T+3. The goal of T+3 settlement was met by the US financial industry in 1995. Maybe he was thinking of the opening lyrics to a classic song: “What a Difference a Day Makes . . . 24 little hours . . .”, sung by a range of artists from Dinah Washington to Amy Winehouse. This could easily be the theme song for the upcoming migration of the US financial markets from T+3 to T+2 settlement. The “nothing-good-ever-happens” stage of the trade lifecycle will be reduced by “24 little hours.” Those “24 little hours” will enable market participants to better manage counterparty credit risk, optimize cash flow, enhance liquidity and harmonize the US with international settlement cycles. It also reduces the risk of investors to the default of a broker such as what the world’s financial markets experienced with the collapse of Lehman. Adding to the positive outcomes of T+2 will be the cost efficiencies that may be found after the remediation and business process re-engineering work takes place. Hopefully these efforts will provide the realization of what has been an industry goal since the early 1990’s: the progression towards a STP (Straight Through Processing) transaction processing environment.

Europe’s Migration to T+2 Settlement

A relatively smooth transition to T+2 in 29 European markets (Germany, Bulgaria and Slovenia were already T+2 markets) took place on October 6, 2014. This was prior to the phase-in which began in June 2015 of a pan-European settlement platform, T2S (Target2 Securities). The ECSDA (European Central Securities Depositories Association), which represents 41 national and international central and international securities depositories across 37 European markets, reported that no country experienced a significant increase in the number of fails with the transition. With expected completion for the migration to a T+2 settlement schedule for equity, municipal and corporate bond trades looming on the horizon for Q3 of 2017, the US is poised to do the same.

Accompanying the groundswell of support for T+2 settlement—from market participants, industry organizations, and regulators—is the recognition that extensive behavioral and technical changes will be required for a successful implementation. As a result of a 2012 cost-benefit analysi[1] commissioned by the DTCC (Depository Trust & Clearing Corporation) and conducted by the Boston Consulting Group, the benefits that will accrue in the form of reduced risk and lower costs outweigh the investment of resources required by the industry. Most industry participants have already begun to address the specific enablers for T+2 preparation and readiness.

T+2 Settlement Participants and Collaboration

T+2 settlement impacts an extensive array of inextricably linked participants in the US financial markets: issuers, asset managers, broker/dealers, custodians, service providers, transfer agents, regulators, and institutional investors (both retail and institutional). As the mainstay of the market infrastructure for clearing and settlement, the NSCC (National Securities Clearing Corporation) and DTC (Depository Trust Company) play a major role in providing for the stability and safety of the post-trade environment and are crucial components of this effort.

Two key industry groups, SIFMA (Securities Industry Financial Markets Association[2]) and the ICI (Investment Company Institute[3]), working with the DTCC formed the Industry Steering Committee (T+2 ISC) with an Industry Working Group (IWG) to facilitate collaboration among industry participants working towards the common goal of T+2 settlement. The group published a white paper on June 18, 2015, "Shortening the Settlement Cycle: The Move to T+2,"[4] that spelled out industry-level requirements for the migration to T+2. These were grouped into four areas:

- *Trade Processing* activities such as the set-up of static data for products and accounts, same day trade matching
- *Asset Servicing* functions that include ex-date and cover/protect activities for corporate actions
- *Documentation* for procedures, client agreements and investor communication
- *Regulatory Changes* required for the certainty of T+2 migration

Support came from the Securities and Exchange Commission (SEC) but with a request by Commission Chair Mary Jo White for a more detailed plan in order to be able to provide the regulatory certainty needed by the industry. After months of effort in collaboration with Deloitte Advisory, the T+2 ISC submitted an Implementation Playbook[5] to the SEC on Monday, December 21, 2015. A 169-page document, the Playbook provides a detailed timeline, project milestones and dependencies, as well as detail for the required remedial activities for each of the requirements. Updates and news regarding T+2 can be found on www.UST2.com.

T+2 Settlement Industry Considerations

T+2 is much more than just an issue for IT departments. Significant industry considerations include the management of fails, collateral management and the impact of T+2 on securities lending and cross-border trade activity. Work-flow changes are needed to adopt what the ISC refers to as "Leading Practices" such as same-day trade matching/affirmation and the automatic enrichment of trades with Standing Settlement Instructions (SSI's) from a centralized database. The exercise and assignment process for options must also be considered.

Preparation for T+2 readiness requires resources from a wide range of departments within each organization, including Operations, Finance, Client Services, Technology, Internal Audit, Risk Management, and Legal and Compliance. Industry groups underscore training and knowledgeable staff as essential elements to the successful transition to T+2.

Organizational Investment and Testing for T+2 Settlement

Individual organizations have already made considerable investment in the requirements definition and gap analysis between their current state and the target environment for the migration to T+2. Some firms are depending on their service bureaus, custodians, or clearing firms to do the heavy lifting. Once business processes have been re-engineered and systems developed (i.e., remediated to meet the demands of T+2), the testing phase will be especially laborious. Besides systems testing in controlled environments where programming changes can be verified based on test cases and expected results, regression testing is also an imperative to ensure that these changes do not introduce new defects in front, middle and back-office systems. Integration of T+2 requirements among the many systems in an enterprise that currently exist in individual business silos (e.g., trade processing vs securities lending vs corporate actions) can be an extremely complex endeavor. Once systems testing has been completed, user acceptance testing that employs explicit testing scenarios requires business Subject Matter Experts (SMEs) to validate the results. For example, in the case where a trade was cancelled and corrected, or an as-of trade was booked, we need to ensure that the correct updates and entries are made to internal systems from the front office to the firm's stock record and general ledger. Once organizations are certified for T+2 preparedness, industry-wide testing, covering all of the key interdependencies among participants is currently estimated to take six months to complete. The time and effort required for thorough testing must also be considered in relation to the day-to-day resources required to "run the business." Throughout this grand-scale project, trades will continue to be executed, cleared and settled; securities will continue to be borrowed and lent; and corporate actions will continue to occur, along with the many other activities that occur on a daily basis.

T+2 Settlement Training is Critical

The ISC's whitepaper referenced previously, "Shortening the Settlement Cycle: The Move to T+2," underscores the importance of staff training to the T+2 initiative: ". . . it is important to ensure that staff are aware of T+2 requirements and are provided the necessary training to mitigate risks and operate efficiently" (page 28). Organizations are very familiar with the Basel Committee's definition of operational risk as "the risk of losses, incurred for inadequate or failed internal processes, people and systems, or from external events." Promoting awareness and education about T+2 and its functional components results in knowledgeable staff.

To that end, GFMI has recently introduced an exciting new one-day training program that will provide important information on T+2 enablers within the context of the business, and their consequential impact on the following areas:

- Static and Reference Master File Data Set-Up for Products
- Standing Settlement Instruction (SSI) Data Management
- Order and Trade Management
- Same Day Trade Matching/Affirmation

- Clearance and Securities Settlement Systems
- Trade Funding and Payments Processing
- Fail Management
- Cross-border Trading and Foreign Exchange lifecycle
- Income Processing and Corporate Actions: ex-date and the cover/protect period
- Margin and Collateral Management
- Securities Lending and Loan Recalls
- Option Exercises and Assignments

T+2 Benefits Will Be Here Soon

It may be just "24 little hours" in reducing the time during which "nothing good ever happens. However, the benefits of migrating T+3 to T+2 settlement will be abundant.

References

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Charlotte Scott is a broadly accomplished financial services executive with over 25 years of comprehensive experience in delivering innovative and cost-effective operations and technology solutions for equities, derivatives and fixed income product lines. Her industry experience as a senior-level manager at Drexel Burnham Lambert, Credit Suisse, Paine Webber, and Bankers Trust provides the industry expertise and background that have made her a recognized subject matter expert in middle- and back-office operations for financial services firms.

Besides delivering industry training seminars, Ms. Scott maintains a flourishing management consulting practice providing advisory services for both buy-side and sell-side firms. These services include new business development and analysis, and strategic process re-engineering, focused on Middle and Back Office Operations for derivatives, equities, and fixed income. Her project experience spans business process re-engineering, policy and procedure development, and third party vendor identification, assessment, selection and customization.

A resident of New York City, Ms. Scott is a graduate of the College of the Holy Cross in Worcester, Massachusetts and the recipient of a Masters in Teaching (MAT) from Rutgers University in New Brunswick, New Jersey.

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