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Time for T+1

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Introduction

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.” Incorporating a riff on Murphy’s Law as it applies to the Lifecycle of Trade (“What can go wrong, will go wrong”), his remarks were meant to encourage the financial industry to shorten the existing T+5 settlement cycle to T+3. The goal of T+3 settlement was met by the U.S. financial industry in 1995. Or maybe he was thinking of the opening lyrics to the old classic: “What a Difference a Day Makes, …24 little hours…”, immortalized by generations of artists from Dinah Washington to Amy Winehouse. This could easily be the theme song for the upcoming migration of the U.S. financial markets from T+2 to T+1 settlement, following the industry’s successful transition from T+3 to T+2 in September of 2017. The “nothing-good-ever-happens” stage of the trade lifecycle will again be reduced by “24 little hours”. Those “24 little hours” will enable market participants to better manage counterparty credit risk, optimize lower margin costs and enhance much-needed liquidity in the capital markets. It also reduces investors’ risk 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+1 are the cost efficiencies, resulting from the remediation and business process re-engineering work that takes place. Hopefully these efforts will provide the realization of what has been an industry goal since the early 90s: the progression towards a STP (Straight Through Processing) transaction processing environment.

Background

As Operations recruits new to the industry, in 1995 the importance of shortening the time between trade execution and trade settlement from T+5 to T+3 was most effectively conveyed to us by the “old timers”. They would regale us with stories from Wall Street’s Neolithic Period of messengers with physical certificates running through the storied streets of lower Manhattan. Any risk? Of course, failed trades or lost or stolen certificates were top-of-mind, but so was the occasional settlement delay (low probability, but potentially high impact Operational risk event?) caused by the messenger who overstayed a visit to the nearby Blarney Stone.

Fast forward to today’s version of the securities trade lifecycle where the hapless messenger was thankfully replaced long ago with electronic settlement systems, but where the March 2020 pandemic brought back the aforementioned words of Commissioner Beese. We witnessed trade volumes and volatility surge in markets where liquidity was already strained. With increased retail volumes in the markets, the volatility in trading “meme-stocks” meant, in some cases, significantly larger margin requirements for retail brokerages, which responded by curtailing customer access to trading certain stocks. The results were headline articles and online commentary that brought to the fore the importance of clearing and settlement – often hidden in the unseen and underappreciated workings of back-offices. In an article from October 23, 2021, *The Economist* described the world of the back-office as a world of "colour-less compliance and post-trade processes," where "the plumbers of finance, toiling behind the scenes to ensure that the plumbing works."[1] Hard to believe, but a question often asked was "Exactly what is clearance anyway?"

Minimizing Risk and Lowering Costs

As the mainstay of the market infrastructure for clearing and settlement, Depository Trust and Clearing Corporation (DTCC) plays a major role in providing for the stability and safety of the post-trade environment and is a crucial component of the push to T+1. In 2020, the DTCC and its subsidiaries cleared and settled more than USD 2.15 quadrillion in securities trades. During that same period of time, the DTCC set a new single day record, processing more than 363 million equity trades, which surpassed its prior high during the 2008 financial crisis by 15%.

In response, margin and collateral requirements to manage credit risk increased as well. According to DTCC, today an average of over $13.4 billion is held in margin every day to manage counterparty default risk in the system.[2] Less time between trade date and settlement date should equate to a reduction in the amount of margin that brokers need to post to clearinghouses.

Accompanying the groundswell of support for T+1 settlement from market participants, industry groups and regulators, is the recognition that extensive behavioral and technical changes will be required for a successful implementation. The benefits that will accrue in the form of reduced risk and lower costs clearly outweigh the investment of resources required by the industry. With a shortened settlement cycle, DTCC's published risk model simulations show a 41% reduction in the volatility component of its margin by moving to T+1. This translates into billions of dollars in margin reductions to members.[2]

Participants

T+1 settlement impacts an extensive array of inextricably linked participants in the global capital markets ecosystem: issuers, asset managers, broker/dealers, custodians, service providers, transfer agents, regulators, and institutional investors, both retail and institutional. Most industry participants have already begun to address the specific enablers for T+1 preparation and readiness. T+1 is much more than just a technology issue for IT departments. Shortening the settlement cycle impacts other parts of the "plumbing" beyond trading, including securities lending, both listed and OTC derivatives, margin and collateral processing, foreign exchange, cash borrowing, and corporate actions.

Same Day Affirmation has been a process improvement objective for many years. The technology exists to allocate, confirm and affirm trades on Trade Date; however, its deployment has been a challenge for many industry participants. For some participants, it will require significant process re-engineering and behavioral changes.

Preparing, Testing, and Training

Preparation for T+1 readiness requires resources from a wide range of departments within each enterprise, 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+1.

Industry participants 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+1. 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+1), the testing phase will be especially resource intensive.

Besides systems testing in controlled environments where programming changes can be verified based on test cases and expected results, regression testing is also imperative to ensure that these changes do not introduce new defects in front, middle, and back-office systems. Integration of T+1 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+1 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". 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.

Staff training is also important to the success of the T+1 initiative. Not just Operations and Technology groups, but other areas such as Internal Audit, Compliance, and Risk Management should be equipped with the knowledge of T+1 requirements and provided with the necessary training to effectively mitigate risks. Most financial firms are already very familiar with the Basel Committee's definition of operational risk: "the risk of losses, incurred for inadequate or failed internal processes, people and systems, or from external events."[3] Promoting awareness and education about T+1 and its functional components results in knowledgeable staff.

Conclusion

Although Beese's thought that "Nothing good ever happens to a trade between trade date and settlement date," there IS a lot of good that can take place prior, during, and after the implementation of T+1. Besides ensuring that the entire Back Office staff and other relevant departments have the foundational and current knowledge that is required to foresee the implications of T+1 and eventual STP, it is also a beneficial step in the right direction of controlling Operational Risk for financial firms, employees, and ultimately the investors.

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.

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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