Future-proofing: Beyond reconciliations

The impact of a T+1 settlement schedule goes far beyond banks' reconciliations processes to affect many lines of business. Consequently, it is forcing a rethink of large parts of systems infrastructure. *Future Banking* talks again to **Roland Brandli** of SmartStream about how banks can best manage the many changes that will result.

Implementing an automated, AI-enabled, lightning-fast suite of reconciliations and exceptions management solutions will go a long way in helping banks to soften the impact of T+1, and prepare them for the advent of real-time settlement when it arrives, but it won't solve all of their problems. T+1 will cut across vast swathes of bank operations.

Some of the ripples of next-day settlement come from a lack of synchrony with other aspects of trading, and banks that appreciate the full impact of a shorter settlement cycle are focusing on building partnerships with technology providers that understand the entirety of their journey.

When T+1 comes into effect in May 2024, forcing firms to pay for and deliver securities faster, the result will be a distinct market disconnect. Many markets will still be using a T+2 settlement model. This means that cross-border transactions will now be taking place under two different settlement cycles, which could increase operational risk.

As the move to T+1 will affect all banks trading securities covered by the SEC ruling, not just those operating in the US, there are implications for both direct currency funding and cross-currency funding. There is also potential for the industry to start changing how it settles cash flow, too. It could, for example, move to real-time gross settlement.

The fact that the foreign exchange (FX) market traditionally settles on a T+2 basis could mean that the cogs in the securities trading machine do not perfectly align, and the gears will grind.

International counterparties wanting to buy US securities will need to prefund their transactions with US dollars, or arrange for a short-dated T+1 FX settlement. Prefunding could have an effect on other investments, perhaps forcing sales a day earlier to have the dollars available, in which case an investment manager would be out of the market for a day.

T+1 will also radically increase the demand for intraday liquidity. The result will be much greater competition for funding sources, and a heightened need for short-term funding. Furthermore, there will be less time to spot and correct any mistakes in the post-trade process, which could be expensive if a late funding request results.

A closer look at liquidity

The implications for liquidity management are huge. Banks must be able to provide the increased intraday liquidity and satisfy growing demand for faster payments. They will need to be able to access more cash and more liquid assets in the short term, which will come at the cost of investment in new technology to facilitate faster settlement.

Once set up, these reconciliations systems would certainly reduce the cost of exceptions management, as finding out about a problem when it has just happened will allow them to address it sooner and more efficiently. T+1 removes that latency between problem identification and solution. Nevertheless, there are more changes to systems infrastructure and process design that will need to happen.

For example, banks will have to overcome the time constraint on securities lending, which arises because the lender will either need to get the original securities back from loan or perhaps substitute the lender with another party. That will give rise to challenges where the security has been sold late in the day on T+0 in order to effect settlement the next day.

To manage the heightened demand for liquidity, treasuries may need to use more short-term funding, such as repos and money-market funds. One potential problem is that these instruments are prone to volatility. If short-term rates rise, or compressed settlement times create greater competition for the same funding sources, banks may face increased costs.

Many of the obstacles that arise with cash and liquidity management can be addressed by putting in place the right controls, so a combination of technology investment and process optimisation will be required. For this to happen, banks will need to make this a prime focus if they are to manage liquidity and

securities lending in less time and still avoid any discrepancies. Otherwise they run the risk of late funding requests if trades have not been confirmed and liquidity projections are not correct.

While some larger banks already have strong intraday and real-time liquidity solutions in place, other industry participants are still unprepared for real-time liquidity management. These players can either deploy additional operational resources to handle the demands of T+1, or they can invest in advanced technology through external partners such as SmartStream.

Whichever path they choose, they will need solutions that deliver real-time cash and liquidity management capability by removing any silos in the systems infrastructure and consolidating all of the necessary data. They will need to capture transactions from internal and external sources to create a single, global view of balances across all currencies and accounts.

Doing so will result in banks having a clear understanding of their funding, borrowing and lending requirements in real time. From there, they will be able to use that timely information about payment obligations to identify any sticking points promptly and, crucially, take rapid and meaningful corrective action.

Collateral and corporate actions

Collateral management is another key area that will be affected by shorter settlement times. Any shortening of the settlement cycle is likely to reduce credit, market and liquidity risk around unsettled trades. Firms can more quickly get from margin call to settlement, and one effect of this will be a potential reduction in the initial margin they are required to post, as part of that calculation takes into account possible market changes between the time firms agree on collateral and settling the trade.

Again, speed of processes is the crucial factor. Some banks have moved to fully automate their collateral management processes, while others still manage some aspects using spreadsheets. Shorter settlement cycles should push banks towards removing any manual processes from the workflow.

"They have to automate all aspects of the collateral management process, including agreement, booking, substitutions and settlement notifications," says Brandli. "They must automate connections to internal and external systems, as well as put in place an efficient fails management process. Easily and inexpensively upgradable technology is also desirable."

End-to-end, automated collateral management solutions are out there on the market, and some have been proved in the field by major financial institutions, and the key elements in their performance have become clear. An efficient and effective solution will connect to a bank's internal systems via APIs, and enable users to send and receive information on a real-time notification basis. Without this seamless interaction, full automation will be hard to achieve.

For corporate actions, which usually have an execution date one day prior to the record date to enable trades to settle in advance of the record date cut off, T+1 will require that execution date and the record date be on the same day. This could cause a spike in reconciliations issues and subsequent market claims unless there is a robust and automated technological solution in place.

Corporate actions, which affect instrument static data and, therefore trade matching processes, will need to be processed within 24 hours of execution to avoid failed settlements, so firms dependent on custodian data and spreadsheets are likely to find T+1 compliance especially difficult. Time zone differences and any event-related FX considerations will compound difficulties further.

With settlement discipline an increasingly important regulatory focus, there is mounting pressure to avoid errors. The need for greater speed will also affect voluntary events – especially in areas such as prime brokerage and securities lending. Real-time processing for the trade life cycle, and the ability to handle complex events and provide visibility of the corporate actions affecting a business will be invaluable.

Resilient in the face of change

Changes in market practice are common, so it is not only T+1 that is making banks reconsider their systems architecture. Indeed, the market is keen to see greater use of Swift and ISO 20022 standards to facilitate the move to an accelerated investment life cycle.

"As the industry undergoes a large migration wave to replace Swift MT messages with ISO 20022, one of the biggest challenges is to supply the rich data required," says Brandli. "This will mean potentially changing underlying legacy systems, which will take time. Another challenge will be the introduction of pre-validation, which is to be welcomed, but not every bank will have this capability, especially the smaller banks with simpler architecture.

"Banks will need scalable, affordable solutions which allow them not only to improve their response times but also enable them to standardise while the different payment solutions still use differing formats and syntaxes," he adds. "Also, It is a general wish among banks to move to managed services more, because they want to get rid of the headache of middle and back office processes."

With the technology investment or the right third-party relationships, banks will know that settlement processes are automated and maximally efficient, only becoming involved when there is an exception. There are plenty of options in preparation for T+1, but they must make a choice and act quickly. ●