The time has come to take T+1 seriously

The move by the US to shorten settlement times for securities trades to one day after the transaction – or T+1 – has presented banks both challenges and opportunities, as well as setting the pace for the rest of the world to follow. *Future Banking* speaks to **Roland Brandli**, director, business strategy at SmartStream, about the implications of T+1 and asks whether banks are ready for the change.

Financial markets across the world are often led by trends emerging in the US, and T+1 trade settlement is just the latest example. Any financial institution that has dealings with the US markets – no matter where it resides – will have to make the effort to ensure its systems and processes are compliant. Furthermore, market authorities the world over – notably in the UK and Europe – will be keen to catch up.

Finalised early in 2023 and due for implementation in May 2024, the adoption of amendments by the Securities and Exchange Commission (SEC) to the Exchange Act Rule 15c6-1 will shorten the trade settlement cycle for most US securities transactions – including all trades in US cash equities, corporate debt, and unit investment trusts – from the current T+2 time frame to trade date plus one business day, or T+1.

Regulators expect the transition to T+1 settlement to bring about a reduction in systemic, counterparty and operational risk, especially in times of high volume and market volatility. Financial institutions' market and counterparty exposure over the settlement period should lessen, which could lead to a reduction in liquidity requirements. Furthermore, capital and operational efficiencies should result in the form of lower costs, standardised industry processes and infrastructure modernisation.

The underlying concept is that time to settlement equates to counterparty risk, and margin

requirements, which are designed to mitigate those risks, represent cost to members. Currently, an average of over $13.4bn billion is held in margin every day to manage counterparty default risk in the system, according to the US Depository Trust & Clearing Corporation (DTCC), which sees a shortening of the settlement cycle as a key step in striking a balance between risk-based margining and reducing procyclical impacts.

The key area in which T+1 affects banks is in reconciliations, which must happen swiftly, efficiently, cost-effectively and with few or no errors. The matching of data – and the rapid correction of any errors in the reconciliation process – is prone to human error unless it is highly automated, and shortening the settlement cycle will only ramp up that risk.

"T+1 is a big thing, but its impact is underestimated," says Roland Brandli, director, business strategy at SmartStream . "It is all about settlement and we see that a lot of banks struggle in the securities middle office to do settlement reconciliations. T+1 affects market standards and connectivity to the payments system, so shortening the trade settlement cycle has an impact on many processes."

A stepping stone to global change

According to a recent survey by Citi, which formed part of its Securities Services Evolution 2023 white paper, accelerated settlements (to T+1) is "the single largest area of focus across all FMIs and participants globally". So, as Brandli says, it is a big issue, though he fears that some market players may take the same kind of approach they adopted for EU Regulation on Central Securities Depositories (CSDR).

CSDR targets post-trade harmonisation in Europe by enhancing the legal and operational conditions for cross-border settlement in the EU. Like T+1 this brought about a big change, but the significance was not necessarily fully appreciated before the new rules came into effect.

"T+1 is a global regulation in that anyone who trades in US securities faces problems of cut-off times, but it may well end up like CSDR, where people only realise the implications afterwards," he remarks. "There is also a lot of distraction because of Swift's introduction of ISO 20022, which affects all payments messaging between banks, and that has put T+1 on the back burner."

The ISO 20022 standard for exchanging electronic messages is characterised by its use of structured, rich data. That data will enable many things, including the ability to uniquely identify all financial institutions involved in cross-border payments in an internationally recognised and standardised way, which could in turn enable pre-validation processes that would reduce the risk of rejected trades.

The richer data required by ISO 20022 will also support much more comprehensive checks on things like AML and KYC, as beneficiary details, addresses and other information will provide more transparency.

"Some banks are holding back on T+1 because ISO formats in the securities world have not been finalised and there is no deadline," says Brandli. "In capital markets, banks have disparate systems. They identify a product to sell at a profit and then worry about the process, and start looking for software. For now, CTOs are getting ISO 20022 for payments in place before moving on to deal with T+1."

Any system that touches the richer set of data will need to be upgraded, so there is a lot for banks to do even before they tackle T+1, but T+1 cannot be put off for too long, not least because it is just the latest step in a global drive for faster settlement that will continue beyond 2024.

Other locations besides the US are adopting accelerated trade settlement. Canada intends to bring in T+1 settlement to coincide with the US, while India has already started a phased transition to a T+1 cycle. Many jurisdictions in Europe and Asia are also weighing up the benefits of a similar move.

Roland Brandli, director, business strategy

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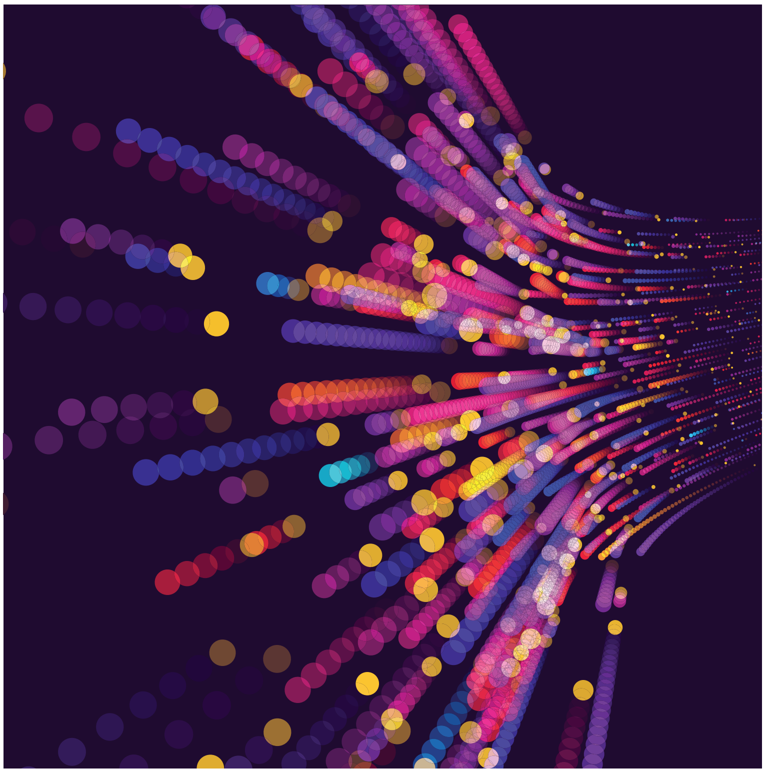
At EU level, the improvement of settlement times is a key regulatory goal in Europe, although the bloc is taking a different approach to the US. The CSDR, for example, introduces cash penalties intended to deter participants that cause settlement failures, while creating an incentive for the timely settlement of securities.

"For me, T+1 has a different flavour than CSDR," says Brandli. "Europe is softer and just imposes penalties on late or early settlement of trades, though some are quite stiff for capital markets with high margins. The penalties need to be big in order to have any impact. Europe has tightened the screw in a different way because it is about meeting what you commit to, whether that is T+1, T+2 or T+3, so it has just chosen a different tack."

The UK, for its part, set up an industry task force in 2022 to explore the potential for faster settlement of financial trades. The Accelerated Settlement Taskforce, will publish its initial findings by December 2023, with a full report and recommendations made by December 2024. ▶



"The Bank of England has looked at more real-time settlement and reconciliation, though the UK has done neither that nor CSDR yet," Brandli explains. "It is sitting right in the middle. It was going to adopt CSDR but opted out on the back of Brexit. The impact of T+1 will only be felt when it comes into play in 2024, so that will cause other jurisdictions to respond."

Ultimately, the US implementation of T+1 will push the global market to follow suit, eventually even moving to T+0 settlement, and the most obvious impact will be on reconciliation. T+1 forces companies to perform reconciliations processing in a compressed time frame, leaving a far smaller window for discrepancies to be identified and fixed.

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Are banks ready to reap the benefits of T+1?

Going forward, financial institutions will require systems that enable real-time, intraday processing. That will mean the automation of not only reconciliations, but also exceptions management.

As market trends push inexorably towards real time, the speed at which data will need to be processed and matched will be too much for a patchwork of legacy systems that rely on any input from manual processes. When exceptions do arise, they will need to be dealt with faster than ever before in order to ensure settlement meets T+1, or even T+0, deadlines.

"We are in the world of 'instant' now, with near real-time payments, so how do you explain to a customer that it takes five or six days to resolve a problem, when the payment itself is instant?" asks Brandli. "Swift did a survey recently and found that 70% of payments exceptions still take more than five days to resolve, which is crazy. How does that fit in the world of instant?"

Increasingly artificial intelligence (AI) is the only practical option to achieve the data-matching speed that is required. SmartStream has implemented AI in its cloud-native reconciliations platform, which is currently the fastest AI data quality application on the market, yet behaves like a consumer app, so requires no training or IT skillset to use.

With the right level of automation and the appropriate use of AI-enabled solutions, banks are in a position to reap many benefits from T+1. US regulators see great potential for cost savings, reduced market risk and lower margin payments. The DTCC's risk model simulations have shown that the volatility component of the National Securities Clearing Corporation's margin could potentially be reduced by 41% by moving to T+1.

Furthermore, T+1 could simply boost the volume of trading.

"If you are in the T+1 world – or faster – it becomes more attractive for people to invest in shares, bonds or other securities," adds Brandli. "It minimises the risk in their investments. The retail banking work has transformed to a world of 'instant' services, and if you run a trading platform you want to sell instantly as prices move. T+1 won't solve that but gets banks to gear up to run processes more quickly. Those who do it better will win."

According to the Citi survey, the industry feels it is well placed to meet the T+1 deadline, but it accepts there will be bumps in the road. When CSDR was implemented in Europe in 2022, settlement failures spiked and penalties accrued. A similar scenario may well happen with T+1 before the market adapts.

So, banks are not fully prepared for T+1, not only because of other priorities such as ISO 20022, but also fragmented systems infrastructure. Undoubtedly, automation is the answer, particularly because T+1 is probably just a precursor to T+0, when processing speeds will be far too great for human beings to handle.

"There are a lot of buzzwords around in the market – cash and liquidity management, corporate actions and more – but first of all it is all about settlement," says Brandli. "Get that right first and everything else should follow. It is possible, but it is a question of how much risk you are willing to take. If a bank gets it wrong, it will take a hit." ●