Ready or not, here T+2 comes

One giant step to T+2, one small step to T+1 and beyond? Denis Orrock of GBST discusses the industry's preparations for the clearing and settlement regime

From 8 October 2014, the capital markets and wealth management industries of Europe will operate a T+2 clearing and settlement regime.

Despite standardised T+2 not being universally accepted as necessary or indeed wanted, the majority of sell-side firms have prepared for the changes by updating software or decommissioning and replacing inflexible, no longer fit for purpose, legacy systems. They have recognised time for change has come.

The same cannot be said for the rest of the industry. There has been a marked lack of interest, investment or action, and the challenge remains for them to fully engage with the required changes. Indeed, many buy-side firms are expecting their brokers to be 'flexible' and continue to allow T+3 settlement.

This relative apathy has knock-on consequences for the sell side, bringing potential for additional risk and regulatory capital requirements.

Through our whitepaper research on introducing T+2 to the Australian equities markets and the combined research with Aite into the US markets, it was observed that smaller firms do not have a consistent cultural, operational or technical appetite for change. Even larger firms were content with T+3 and were struggling to keep up with the operational challenges that arise with a sustained period of regulatory change.

Equally important to remember is the fact that T+2 is not applicable to all transactions and asset classes (ie, exchange-traded funds and American depository receipts), for example OTC transactions and securities lending exhibit different transaction lifecycles. Consequently, despite the T+2 deadline, if settlement systems are unable to cope with this wider range of settlement regimes for asset delivery, settlements may still fail. It is clear that one size no longer fits all and any back- and middle-office process/technology must be able to cater for a wide range of requirements and settlement methods

A long time coming

Thirteen years ago, the Giovannini Group identified a number of barriers to settlement process effectiveness and market efficiency. Today, with mandatory T+2 transition imminent, it would not be true to say that the market as a whole is ready. This is despite all the discussion, seminars, workshops, forums and industry events on the subject, plus all of the significant technology advancements that have happened during this time.

The key concerns identified all those years ago were restrictive technology, non-compliant market practices, non-standard taxation and legal uncertainty. To become more effective, the industry had to change. The changes were needed to provide improved safety, market efficiency and transparency of cross-border transactions, delivering financial and operational benefits as trade volumes, velocity and value increase.

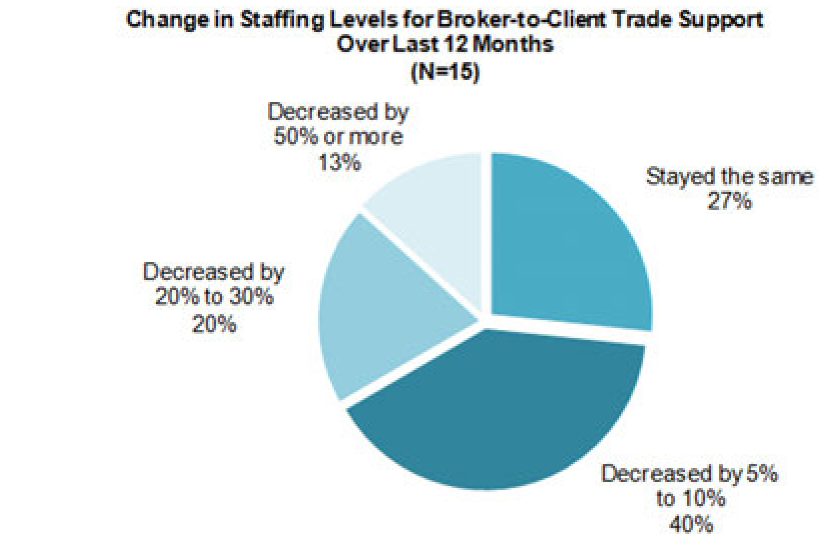
The industry has also been 'incentivised' to comply, with the threat of fines for late settlements. How long it will take for any such sanctions for non-compliance to come into effect is another story.

The compression of the transaction lifecycle is intended to improve integrity of the markets, but it can only be successfully achieved through widespread implementation of appropriate technology.

Ready or not, people are key

The Association for Financial Markets in Europe's Recommendations on Implementation Impacts of T+2 state that where increased trade volumes are expected, sufficient staff should be available through the migration and transition periods, central bank liquidity requirements should be reviewed, and requests for readiness confirmed prior to 8 October.

Figure 1: Change in Institutional Brokerage Firms' Overall Budget for Trade Support



Source: Aite Group interviews with 15 institutional brokerage firms, Q4 2012

However, pressure on heads of operations to continually cut costs (see Figure 1) has meant reducing headcount, with more than 70 percent of surveyed firms indicating 5 to 50 percent staff reductions in trade support functions. Even if this were not the case, increasing headcount, during transition, without the associated process adjustments could actually exacerbate the problem of rising fail rates.

Sell-side firms must be ready to cope with counterparties that are not as prepared as they are for T+2. They will need to work with their providers to ensure the successful transition for all.

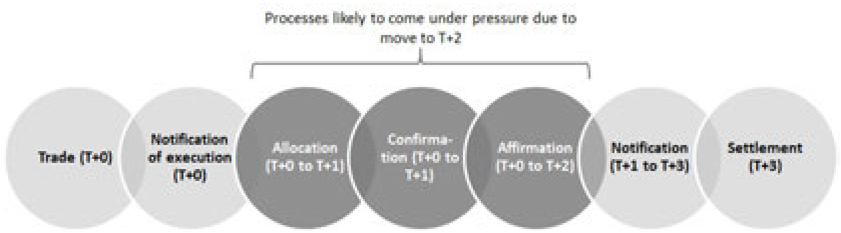
One area to be addressed when moving to T+2 settlement is the elimination of trade failures. With complexity and potential for failure at each stage of the trade lifecycle, successful settlement is contingent on the previous action being completed. With increased time pressure at each stage standardised electronic mediums (such as ISO standard or FIX messages) are essential and provide a clear audit trail.

The manual processes of pre- and post-trade matching and settlement of the past do not fit the nature of today's dynamic markets and the need for compressed settlement times. More efficient capital allocation with less risk has only been achievable through complete market review, investment in technology and (most importantly) action.

At GBST, we believe that implementation of innovative, smarter, cost-effective technology and operational process change is the key enabler and differentiator for effective T+2 participation on a global basis. However, the nature of the capital markets and the ever-pressing need to reduce costs and risk means that T+2 implementation is unlikely to be the end of the story.

These are exciting times with T+2 groundwork in place and take-up of scalable, faster and more efficient processes becoming an accepted norm. We believe that T+2 is likely to be just another step toward an automated efficient settlement standard with global T+1 or even T+0 capability possible in the longer term. **AST**

Figure 2: Steps in the Settlement Lifecycle Under Pressure Due to a Move to T+2



Source: Aite Group

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