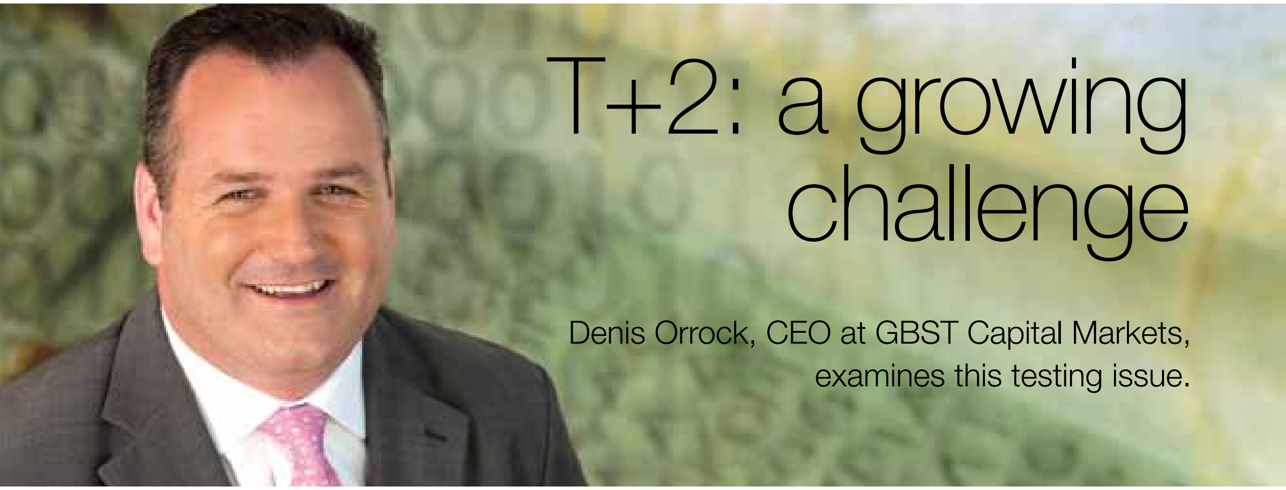

T+2: a growing challenge

Denis Orrock, CEO at GBST Capital Markets, examines this testing issue.

The evolution of the problem

In order to reduce the current high rates of trade fails and associated costs and operational risks, particularly on cross-border transactions, the European Commission published proposals for improving securities settlement and access to Central Securities Depositories (CSDs). The rules, termed CSDR (Central Securities Depositories Regulation) necessitate a move to T+2 or less for all European Union (EU) markets by 2015.

Certain EU countries, such as Germany, Bulgaria and Slovenia, already have a T+2 settlement policy so there is a precedent within Europe that proves that processing transactions within these timeframes works, adding weight to the proposal for the remaining member states to follow suit. The original deadline for the adoption of T+2 was January 2015 but, as is well publicised, this is now firmly targeted for 6th October 2014.

The key item within the proposal is the shortening of the securities settlement period across Europe from three days, in the majority of European markets, to two days (T+2). The introduction of financial penalties for trades that fail to settle on time has been supported by the majority of market participants, being viewed as gentle encouragement for faster and more efficient settlement practices – practices that lower counterparty risk. Will all financial institutions be ready for a transition to T+2 by this time?

Implications for asset managers and investment houses

Perhaps the most notable item from a move to T+2 is that activities in the settlement process will come under greater pressure as a result of the reduction of the overall cycle by a day or more, such as the trade allocation, confirmation, and affirmation processes. The goal of these processes is to enable the asset manager and the institutional broker to agree upon and match the details of a trade in order to clear and settle the trade; this includes adding data that may be required for the process to progress. The post-trade communication and validation processes are therefore based on the checking and verification of a set of key data items.

Depending on convention, settlement details, fees, and commissions are added throughout the post-trade messaging process or via an external standing settlement instructions (SSI) database. In a T+3 environment the trade allocation, confirmation, and affirmation processes tend to take place at some point between trade date and T+2 (usually on or before T+1). By taking a day out of the lifecycle, firms will be forced to perform a higher volume of these processes on T+0. More specifically, T+2 project teams will need to address:

- same day affirmation processing, requiring verification of the trade to be completed on the same day the trade is executed;

- a potentially substantial increase in the number of trade failures – front offices are currently struggling to confirm and settle those trades at T+3;
- pressure on STP workflow – resulting in a higher number of settlement failures due to inefficiencies in systems or data issues;
- administration of additional fines levied for not reaching T+2.

Reviewing settlement failure rates (sourced from ECSDA, BATS and Aite Group as of March 2012) fail volumes vary across the main European markets with Slovakia and Portugal topping the table with in excess of 17% fails, through 4-6% for the larger markets of Germany and UK, down to 0.2 % for Spain. These percentages can represent substantial processing volumes that now require automated rectification and validation.

T+2 will also have an impact outside the European Union, with cross border transactions needing to be brought into line with the T+2 deadlines. The Depository Trust and Clearing Corporation (DTCC) in the US is pressing for a move to shorten their limit from T+3 to T+2. Meanwhile in the Asia Pacific region markets such as Japan and Hong Kong have already achieved T+2 and are considering a move to T+1.

The operational burden

The primary areas of focus for investment for brokers is around enhancing current systems workflow and automation, in order to meet the requirements of a compressed time frame; and improving interfaces to capture more data in order to reduce manual interaction. Naturally addressing these areas will mean a thorough review of business processes, and whilst circumstantial evidence suggests that there will be an initial increase in fails and settlement team workload, matters will settle down, normalising with reduced fail rates to those currently experienced.

One of the biggest problems concerning asset management houses is their extensive use of spreadsheets for trade matching and other back office processes, if these spreadsheets bear incorrect SSIs, the trade fails and there is little time for remedial action under T+2.

The biggest outlay for the majority of participants will be in the review and analysis process itself in order to determine what process changes are required and test that systems are ready for a move to T+2. An example of this could be within the trade cancellation process, where manual checking of data to determine accordance with market rules could be ruled out due to the compressed time frame.

There are likely to be some technology investments required around adding new interfaces between systems and in improving core processing systems to cope with the shortened settlement cycle. The extent of these investments will depend on the age and capabilities of the firm's current internal infrastructure.

To make T+2 work, there really is a need to automate task management and rules for the rectification of failures. Middle office processes such as trade confirmations and affirmations that are manually intensive today must be substantially reduced. If an SSI fails, firms will need an ALERT, or equivalent interface that will identify the piece of information that is missing or incorrect. Buyside firms must migrate from batch or end-of-day processing to near real time processing and implement data improvement initiatives to improve the accuracy of SSI data.

Perhaps an obvious statement is that firms should aim for improvement in overall pre-settlement matching performance – matching an instruction for settlement as early as possible once the trade is executed will allow for operational risk reduction.

The T+2 requirement also comes on the back of FTT, EMIR, T2S and a whole host of other regulatory reporting obligations that will require already stretched resources to extend even further. The opportunity to outsource this task is something to consider, but for UK asset managers in particular this option has become arguably more complex since the Financial Conduct Authority's (FCA) thematic review into outsourcing.

T+2 is becoming a global phenomenon. It is time for firms on the buy- and sellsides to prepare a scalable solution to a growing concern. ■