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Race Against Time: The Global Challenge of T+1

David Veal, Senior Executive: Client Solutions, considers the impact of differing levels of readiness for T+1 and how this has become a global challenge – and a race against time.

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1. Introduction

This document looks at the challenges remaining now that the deadline for T+1 in North America has passed.

Whilst there are understandably concerns around Europe lagging behind in adopting the T+1 settlement cycle as North America transitioned to T+1 on 28 May 2024, this is arguably only the tip of the iceberg. The impacts of a global misalignment of settlement cycles will propel the financial markets into a state of flux that may take years to unravel. It will also create operational hurdles that will demand senior management time and technical resources that are already overstretched.

Some industry commentators criticised US regulators for failing to account for the global interconnectedness, doubting a smooth transition possible given the technological limitations of European firms. Other experts expected a rise in settlement failures as firms rushed to employ temporary solutions.

With India forging ahead with T+1 since its adoption in 2023 and other Asia-Pacific jurisdictions at differing levels of preparedness, what has become clear is that T+1 has now become a global challenge – and a race against time.

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2. The Aftermath: T+1 in North America

Although the US, Mexico and Canada were engulfed by the transition process for some time now, significant operational challenges remain. Here is a brief overview of these issues.

Manual processes among small firms

The shift to T+1 in North America has varying impacts depending on the size of firms. Smaller firms are more likely to see an increase in settlement fails, simply given the disparities in the size of teams that will have to deal with reduced settlement times. Some small firms are still confirming trades via email and fax, and smaller firms generally have legacy batch overnight systems that will not be able to cope with increasing volumes that will come as a result of T+1 – meaning added costs to implement new systems to avoid settlement fails.

The benefits of T+1 will be harder to see in smaller firms with smaller operational footprints and these firms are likely to lag behind tier one financial institution.

ETF mismatches

This issue arises when a US ETF contains non-US securities, which will continue to settle on a different cycle (T+2 or more) in their local markets, creates mismatches between the settlement of the ETF shares and the underlying securities. The US regulators left it to the industry to devise solutions for these operational challenges.

The potential funding gaps during subscriptions/redemptions of ETFs due to the settlement cycle mismatch is identified as a priority concern by ISSA (International Securities Services Association). Industry participants acknowledge the issue and expect increased use of collateral to manage mismatches, which could lead to higher costs.

Some experts warn that the increased administrative costs could potentially harm the US domestic ETF market, with investors seeking alternative products with lower risks and costs.

Supporting collateral management

By having a higher rate of STP, firms can more readily reach a position whereby they can start to effectively manage collateral, with less likelihood of wrongly estimating the collateral requirements. STP results in accurate data, and firms need accurate data to manage collateral and cash management.

Prefunding is likely to increase with the need to allocate cash or collateral early to facilitate settlement for T+1. This added cost is compounded where a foreign exchange (FX) transaction is needed, where standard settlement is T+2.

Better managed settlement instructions

One reason why firms need to effectively manage settlement instructions is because they can't afford to let T+1 make them breach the Settlement Discipline Regime (an element of the CSDR). Some commentators might argue that this is unimportant, but we believe that firms can't let T+1 increase their number of failed trades.

If firms want T+1 to result in less trade fails, then they should look no further than the settlement instructions - one of the key reasons why trades fail today. In T+1, the day of grace is eliminated and firms won't discover until settlement date that the trade is not matched up on the same settlement platform.

FX settlement workarounds and CLS Bank

There are significant issues faced by buy-side firms in meeting foreign exchange (FX) settlement deadlines with the shift to a T+1 settlement cycle. The main problem is the tight timeframe between the market close and the CLS netting deadline, especially when dealing with high volumes of end-of-day trades. CLS Bank is integral to FX transaction netting and has a critical role in timely settlements. Firms must consider the operational challenge of submitting FX transactions to CLS netting in time, given the constraints imposed by custodian processing.

Several workarounds were explored by buy-side firms, including executing bilateral FX directly with custodians (bypassing CLS), pre-funding US dollar accounts, and creating estimated FX forecasts earlier in the day. For firms in Asia, the time-zone differences exacerbate the issue, leading to trends like pre-funding US dollar accounts or considering alternative solutions like 24-hour desks or custodian assistance.

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3. Staying On Track: T+1 in Asia-Pacific

This section discusses the challenges faced by firms in the Asia-Pacific region now that the settlement cycle for trading in North America has been shortened.

Some Asian firms are already used to working with shorter settlement times. For example, India moved to T+1 last year and the Hong Kong Exchange's Northbound Stock Connect (connecting Hong Kong with mainland China) adheres to China's T+0 settlement timescale. Other jurisdictions are a long way behind.

Market experiences to date

In contrast with the 'big bang' approach being adopted by the US, India chose a phased transition, extending from February 2022 to January 2023. Securities were grouped into tranches and moved to T+1 on a monthly basis, with the smallest stocks by market cap transferring first. The logic was to give the market time to adjust to the new cycles and timeframes.

Initial feedback from India has been positive, with only a minor issue in the early increases in FX fees as demand was squeezed into a tighter window on the morning of T+1. Measures to ease the transition have included arranging FX settlement on a T+1 basis, holding long balances from sales proceeds, earlier submissions of client FX booking instructions and an increase in funding solutions from custodians.

Meanwhile in Pakistan, the National Clearing Company of Pakistan created a working group of key stakeholders in September 2023 to begin its move toward T+1. Likewise, the Australian Securities Exchange (ASX) is engaging with stakeholders on a potential move to T+1 from T+2. Many other markets in the Asia Pacific region, however, have shown little interest in shortening their settlement cycle further (the Philippines, Malaysia and Japan only relatively recently moved to T+2).

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In Singapore, the settlement of trades executed on the SGX securities market takes place on the second market day after the trade date (i.e. T+2). Given its substantial base of high-net-worth individuals, firms in this market are significantly exposed to US securities markets. It is anticipated this will put them under immense pressure. According to a recent global survey of market participants by financial data vendor SIX, 39% of respondents in Singapore foresee a higher rate of settlement fails as a main consequence of the implementation of T+1 in the US.

Asset managers in Hong Kong have a very short window of around 3 hours (4am to 7am) to settle US securities trades due to the time difference. The shortened settlement cycle could lead to funding gaps, as proceeds from sales in markets with T+2 or T+3 settlement may not be available in time to fund purchases in the US on T+1.

Issues to contend with

Firms in Asia need to extend working hours, particularly on Friday nights, to accommodate the shorter settlement window in the North American markets. Pre-funding trades could also be an issue for Asian firms investing in North America due to limited time overlap with those markets. Some global asset managers may centralise funding from Europe or London operations to avoid having Asian teams work late.

Firms need to work closely with service providers and adopt tools to increase operational efficiency. Strategies like pre-allocating trades at order booking stage, used by large funds in India's T+1 market, need to be adopted more widely.

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4. In The Blocks: T+1 in Europe and the UK

The roundtable held by the European Commission in January 2024 to discuss the transition of EU securities markets from T+2 settlement to T+1 settlement settled the issue of the EU following North America in its quest to shorten the settlement regime.

There was widespread agreement among industry participants that the EU needs to move to T+1 to align with the shift to T+1 in North American markets. The transition to T+1 is, however, seen as more challenging than the previous move from T+3 to T+2, requiring significant automation, process changes, and technology investments, especially for smaller firms. Concerns were raised about increased settlement failures, risk management challenges, and costs outweighing benefits for some firms during the transition period.

Europe launched a T+1 taskforce led by AFME (Association for Financial Markets in Europe) in March 2023 to assess the implications, but there has been a lack of international coordination so far. AFME noted that the US move to T+1 created a global misalignment of settlement cycles for global institutions.

The UK has confirmed the adoption of T+1 but is uncertain about aligning with the US date or waiting for Europe. Meanwhile, ESMA (European Securities and Markets Association) is awaiting research from AFME on the implications of shortening the settlement cycle in Europe. The findings are not due until the end of 2024.

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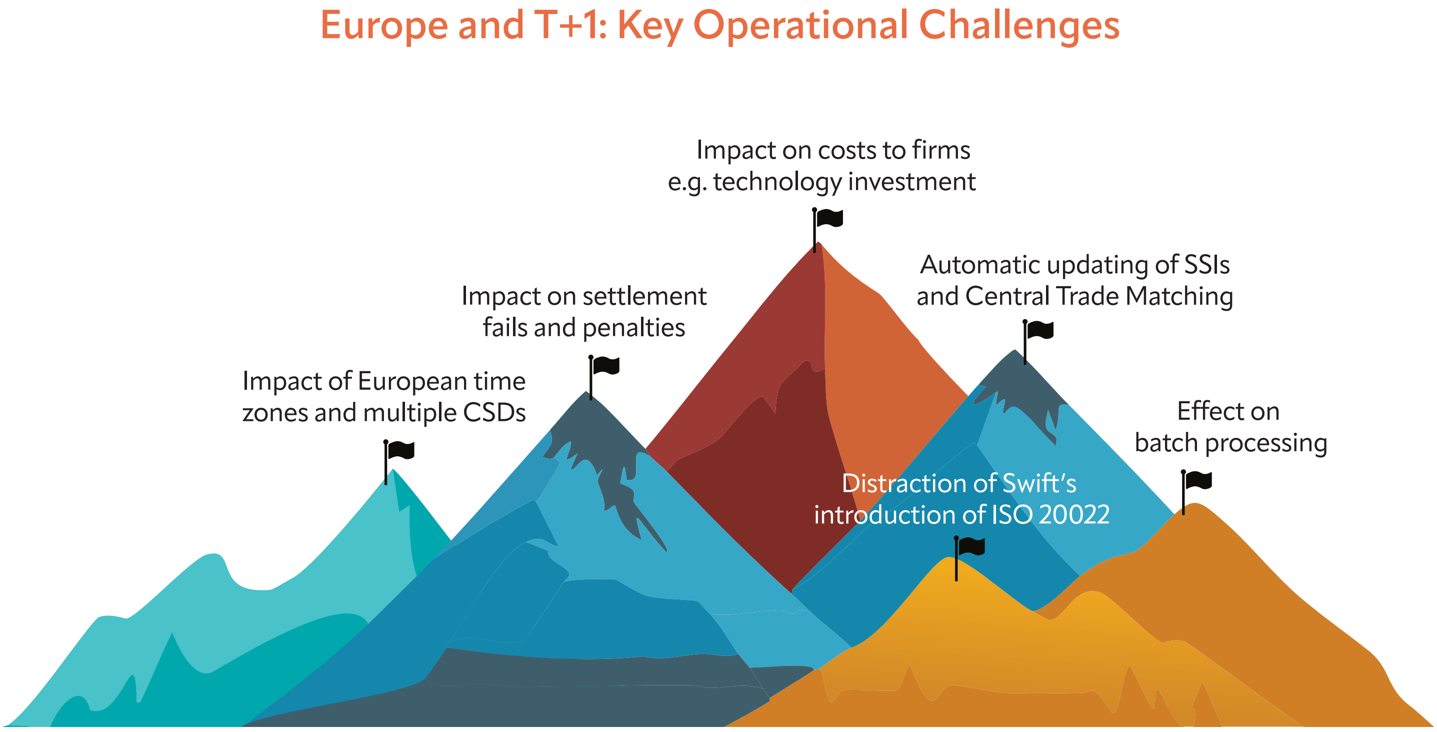
Operational challenges of T+1 in Europe

The infographic below summarises the main operational challenges of T+1 for European firms.



Shortening settlement cycles presents major challenges for Europe given its complex market structure with multiple markets, securities depositories, regulators, and entrenched practices. And unlike the US, where settlement can be achieved without CSD level matching in certain circumstances, Europe requires that a match take place before securities are delivered.

Firms are looking at increasing automation, front-to-back office collaboration, and operational improvements to prepare for shorter cycles. However, the fragmented European landscape makes coordinating this transition very difficult.

The impact on penalties

One major cause for concern is the effect on failed trades (and therefore penalties) of a move to T+1 in Europe. ESMA has issued a consultation proposing changes to increase penalties for settlement fails under the Central Securities Depositories Regulation (CSDR). The proposals involve either introducing progressive penalties that increase the longer a fail persists, or changing penalty amounts based on the liquidity of the asset class.

Both proposals would significantly increase penalty amounts, potentially by over ten times the current €1.7 billion in annual penalties. Market participants have raised concerns that:

- **Higher penalties could widen bid/ask spreads as firms factor in potential penalty costs**
- **It would require costly system changes to calculate the new penalties**
- **Higher cash buffers would be needed to fund increased penalty amounts**
- **More claims between parties may need to be processed**

The industry argues increased penalties alone won’t solve settlement inefficiencies. Structural reforms are also needed, like addressing operational weaknesses causing fails, enabling partial settlement functionalities, extending settlement windows, and client education on providing correct instructions.

There are also worries that significantly higher penalties, combined with a potential shift to T+1 settlement cycles, could create a “perfect storm” challenging back-office operations. Overall, the industry is pushing back on the penalty hike proposals, arguing more comprehensive solutions are required.

The complexity of the European market makes the path to T+1 settlement uniquely challenging compared to markets like the US. Concerns exist that smaller, less technologically advanced firms may struggle to keep up, causing gridlock and settlement failures if they are left behind in a reduced cycle.

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Conclusion

While there are concerns about Europe lagging behind in adopting T+1, corfinancial highlights that this is just the tip of the iceberg due to the global interconnectedness of financial markets.

- **Operational challenges remaining for T+1 in North America, such as manual processes at small firms, mismatches with ETFs holding non-U.S. securities, collateral management issues, settlement instruction problems, and FX settlement workarounds needed.**
- **Experiences and challenges for the Asia-Pacific region, including time zone differences creating tight windows, need for workflow optimisations, potential manual processes or temporary solutions, and impact on FX, hedging, derivatives and ETFs.**
- **Europe's path to T+1, with operational hurdles like fragmented market structure, settlement fail penalties, automation needs, and scepticism that benefits outweigh costs for some firms during transition.**
- **Concerns around lack of international coordination, increased settlement failures due to laggards, penalty calculations, and smaller European firms struggling to keep up technologically.**

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With the arrival of T+1 trade processing, the pressure to automate and streamline post-trade processes has never been higher. Falling behind can result in consequences for your firm's efficiency and success.

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BITA Risk provides Investor Profiling, Portfolio Analytics, ESG Management and Portfolio Monitoring solutions to wealth managers through the BITA Wealth application. Available as individual modules or as an end-to-end solution.

SureVu empowers buy- and sell-side firms to efficiently monitor and track security trades throughout the settlement lifecycle, enabling users to proactively manage and oversee settlement exposure.

salerio is a post-trade processing solution that enables asset managers, hedge fund managers and securities/fund services firms to automate the flow of securities and treasury trades from matching through settlement.

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