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Fitch: US, Canada T+2 Settlement to Reduce Counterparty Risks

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(The following statement was released by the rating agency) NEW YORK, September 05 (Fitch) The introduction of a shortened settlement cycle for most financial products in U.S. and Canada will reduce operational and systemic risks between each party and improve capital and efficiency in the financial system, says Fitch Ratings. Over the long term, this should result in cost savings for trading firms, including trust and processing banks, broker dealers and buy-side firms. Initially, there could be some operational challenges associated with the infrastructure upgrades to meet the shortened settlement cycle, particularly for smaller companies. Beginning on Sept. 5, most financial products in North America are required to settle transactions within two business days of a transaction (T+2) as opposed to three (T+3). The conversion to T+2 will apply to equities, corporate bonds, municipal bonds, unit investment trusts and other financial instruments comprised of those securities. T+2 will benefit multiple financial market participants. It will enhance capital efficiency as central counterparty margin is reduced, allowing firms to put capital to better use. Trust and processing banks and broker dealers could especially benefit from lower capital requirements for margin or clearing funds; The Boston Consulting Group (BCG) estimates a 15%-24% decrease for margin/clearing fund requirements. Process efficiency will improve as a result of financial firms using straight through processing, which will harmonize with global markets currently operating in T+2. The duration of counterparty risk for retail brokers, institutional broker dealers and actively managed buy-side firms (hedge funds, alternative investment managers, etc.) will also lessen as the proceeds from trades will be settled more quickly.

A number of changes to industry practices in recent years have allowed U.S. and Canada to commence T+2, including those involving trade processing, asset servicing and greater documentation automation. Cost for T+2 infrastructure upgrades such as automation of confirmation/allocation process will vary by both type and size of market participant. BCG estimates that large firms will have to invest on average $4.5 million to upgrade their infrastructure, with institutional broker dealers at $5 million on average and buy-side firms anticipated to pay the least at $1.1 million on average. Estimates for required investments in infrastructure upgrades are $1.1 million on average for medium and small firms, $4.5 million for medium-size custodian banks and $300,000 for small size buy-side firms, according to BCG.

BCG projects the total investment required to upgrade infrastructure as $616 million and operational cost savings would be $190.5 million per year, which means that infrastructure upgrades would have a payback period of a little over three years.

When Europe transitioned to T+2 in 2014, the operational track record was mixed. According to the European Central Securities Depositories Association, three days after the transition, 11 out of 17 markets reported a lower number of failed instructions compared to the prior week, five markets remained without failures and only one market increased in the number of failed instructions by less than 10%, which was within range of normal fluctuations in the failure rate. However, a European Post-Trade Group survey following the T+2 implementation found that between 35% and 45% of EU clients, including small buy-side firms, still had efficiency problems and had non-straight through processing. European Securities and Markets Authority noted the pressure on the post-trade process had increased though same-day affirmation as T+2 still offered the possibility to affirm later than the trade and instruct settlement on the settlement date. Contact: Sean Pattap Senior Director Financial Institutions +1 212 908-0642 Fitch Ratings 33 Whitehall Street New York, NY Dean Hrozenchik Analyst Financial Institutions +1 646 582-4746 Justin Patrie, CFA Senior Analyst Fitch Wire +1 646 582-4964 Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.