NORTHERN TRUST BANKING & MARKETS

Preparing for the 2024 Global Securities Settlement Cycle Crunch

Getting ready for the compression of the T+1 securities settlement cycle in May this year requires careful consideration, particularly for firms engaging in US stock trading from other global locations in non-USD base currencies. This consideration extends to firms situated in the United Arab Emirates, which is eight hours ahead of New York, the primary trading centre in the US. Gerard Walsh, global head of Client Solutions, Banking & Markets at Northern Trust, delves into the crucial matters facing Abu Dhabi based managers, and provides suggestions for effective preparation.

By May this year, the trade settlement cycle for US listed securities is stated to decrease from two days (T+2) to just one day (T+1). This change presents a variety of challenges for managers investing in US assets, irrespective of their global location. These challenges are especially acute for managers in locations and time zones with limited overlap with the trading hours of US markets, such as the European and Asia-Pacific markets. In the United Arab Emirates, where The New York Stock Exchange is a primary trading hub, the market opens at 9:30 am Eastern Daylight Time equivalent to 5:30 pm in Abu Dhabi.

Background

The shift to the T+1 settlement cycle stems from the US Securities and Exchange Commission (SEC) adopting an amendment to introduce T+1 to the US market by 28 May, while the Canadian Capital Markets Association has declared that Canada will transition a day earlier on 27 May. India moved to a T+1 environment earlier this year. The rationale behind moving to T+1 is largely investor-centric, aiming to curtail overall risk exposure to unresolved trades and mitigate the likelihood of price fluctuations in the underlying securities during the settlement process.

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Considerations

Given that the US represents the world's largest and most liquid market, with the percentage of foreign-owned US equities surging by 50% in the past 12 years to exceed USD12 trillion, this change will undoubtedly carry a significant impact.

Abu Dhabi-based managers holding these securities will need to think about several things in the run-up to the cycle shortening.

There are concerns that this change will escalate the cash funding costs of the trade settlement lifecycle, introducing a new drag on fund returns. The shift to US T+1 implies a necessity for funds to maintain larger cash reserves to alleviate settlement-related funding strains and safeguard against uncertainties like currency transaction costs associated with trading. This can potentially lead to an unwelcome effect on fund performance, making it less appealing to investors.

Another pertinent question arises: Who will bear these costs? It appears probable that such increased expenses will be transferred to end investors, whether through direct or indirect means.

Another process demanding meticulous thought and scrutiny is the fund subscription process. Currently, it is commonplace for cash payments related to fund subscriptions to lag behind the subscription itself by several days. This is less of a concern within the existing T+2 settlement cycle, as the necessity for overdrafts and other forms of funding is diminished. Nevertheless, in a T+1 environment, trades initiated by subscriptions may need to be settled several days before the receipt of inbound cash payments. Managers must thoroughly evaluate the existing processes in conjunction with their conventional sources of cash flow funding. In many instances, managers rely on facilities such as overdrafts and agreed-upon cash reserves from brokers and custodians. Managers must ascertain that the entities they collaborate with for these provisions possess the capability and willingness to accommodate any necessary increases within the T+1 framework.

This is especially true for managers running funds with lower levels of assets under management (AUM) and in situations where there are restrictions and limitations on a fund's permission to hold cash. For example, the European Union's Undertaking for the Collective Investment in Transferable Securities (UCITS) designated funds can hold a maximum of 10% of net asset value (NAV) in cash. Clearly, that's not an issue at scale, but for funds with lower levels of AUM, subscriptions in size may raise issues.

Managers may also need to think carefully about market events such as index rebalances, market holidays, and extended weekends where prolonged settlement terms will necessitate extended cash facilities, which will come at a cost.

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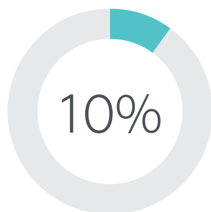

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Another factor amplifying the cash drag on funds is trade-related currency transactions. The halving of the settlement cycle eliminates the two-day buffer period during which managers were previously able to arrange trade-related currency movements. Consequently, firms and funds will need to reevaluate their FX trading arrangements. The objective should be to execute trade-related FX transactions on the same day as the trade itself, as closely aligned in timing as possible. It's a quirk of the FX market that significant trading volumes occur towards the end of the US market day, and this poses a narrow operational window for firms located outside of the US, particularly in Asia-Pacific nations. One sensible resolution might involve adopting cash pre-funding processes similar to those necessary in T+0 markets like Taiwan. However, this pushes the utilization of cash even earlier in the settlement cycle, leading to extended reliance on temporary loan facilities and higher associated costs.

Preparing for T+1

Having said all that, is there a viable path forward?

I believe there is. It seems almost too obvious that the best plan for US T+1 is to "review everything and prepare thoroughly." Firms and funds – especially those in time zones with the least overlap with US market hours such as Abu Dhabi – will need to go through every step of the trading lifecycle and ensure they understand all the moving parts. They'll need to make sure they've been through the whole process with a fine-toothed comb and find ways to orchestrate an ecosystem that helps them mitigate as many of the impacts of the shortening of the cycle as possible.

Workable solutions are available now from solution providers who can support the full execution-to-custody lifecycle, with trading, matching, clearing and settlement, and trade-related FX embedded in a single seamless flow-through lifecycle. These full lifecycle solutions will be especially effective where funds and managers orchestrate their activities alongside providers with US resources supporting trading and trade-related FX in US market hours.

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Our outsourced trading capability – Integrated Trading Solutions (ITS) – combines worldwide trading expertise in equities and fixed income, exchange-traded derivatives, futures, and exchange-traded funds (ETFs) across global markets. It provides coverage from multiple trading locations, access to high-quality liquidity and fully integrated middle and back-office service.

ITS can be paired with our Foreign Exchange services to provide asset managers and asset allocators with an end-to-end fully outsourced solution – from trade execution to FX settlement.

To learn more

To find out more about how our capital markets solutions can support your organisation, please contact your local Northern Trust business development teams or:

Gerald Walsh, global head of Client Solutions, Banking & Markets

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