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Release of DTCC-Commissioned Study Regarding A Shortened Settlement Cycle

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TO: SECURITIES OPERATIONS ADVISORY GROUP
ACCOUNTING/TREASURERS COMMITTEE No. 15-12
EQUITY MARKETS ADVISORY COMMITTEE No. 33-12
OPERATIONS COMMITTEE No. 40-12 RE: RELEASE OF DTCC-COMMISSIONED STUDY REGARDING A SHORTENED SETTLEMENT CYCLE

To initiate a discussion regarding the current length of the securities settlement cycle, in May 2012 the Depository Trust and Clearing Corporation (DTCC) commissioned Boston Consulting Group (BCG) to undertake a study [1] of the potential investment and resulting benefits associated with shortening the securities settlement cycle. In 1995 a trade date plus three days (T+3) settlement cycle was mandated to complete securities transactions. In the intervening years, however, technology and post-trade processes have both significantly evolved. Considering the evolution of the settlement practices, DTCC determined that an analysis of moving to a shortened settlement cycle was warranted and engaged BCG to complete the study.

Scope of BCG Study

The study analyzed settlement processes for U.S. equities, corporate and municipal bonds, and addressed three primary issues: reducing risk, optimizing capital (for the sell side), and reducing costs through improving process efficiency. The study presents results regarding shortening the cycle to either trade date plus one day (T+1) or trade date plus two days (T+2).

In the report, BCG used a three-step approach to assess industry preparedness, feasibility of change to T+1 or T+2, and the appetite of stakeholders for moving to a shorter settlement cycle. First, a broad range of industry stakeholders were interviewed (70 one-on-one interviews) or surveyed (260 firms), including institutional and retail broker-dealer firms, buy side firms including asset managers, pension funds and hedge funds, custodian banks, and other market participants such as registered investment advisors, securities transfer agents, service bureaus, exchanges, and market utilities. Since shortening the settlement cycle is also a subject of global discussion, BCG reviewed benchmarks and held interviews with a number of international clearing utilities, including those from Germany, the European Union, Hong Kong, and Canada. Finally, several in-depth working sessions were held with 10 firms to validate data regarding potential investments and cost savings, assumptions used in analyzing data, and the models formulated by BCG from the participant input.

Results of BCG Study

Prior to completing the cost benefit analysis, BCG found that 68% of participants contacted in the initial outreach support a move to a shorter settlement cycle. Of those, 27% considered the shortened cycle as a high priority without the affirmation of need by regulators.

An array of benefits was indicated by the study participants. For example, over 55% of participants cited risk reduction for their firms as a benefit of a shortened cycle while over 70% of firms cited the benefit of risk reduction across the industry. Buy side firms indicated a reduction in loss exposure on in-process trades and faster issue resolution as the primary benefits. Those buy side firms with significant cross-border business indicated benefits from global harmonization around a cycle of T+2, an emerging standard outside the United States. Generally participants cited operational efficiency and process improvement as a benefit, but buy side firms found loss exposure reduction as the greatest benefit.

Competing priorities and other regulatory initiatives generally were indicated as obstacles to implementing a shortened cycle in the near term. In addition, participants cited impediments such as settlement of physical securities, challenges with securities lending, and foreign exchange transactions as other issues which must be addressed when considering a shortened settlement cycle.

BCG developed two models – one for T+1, the other for T+2 – to assess required investments and potential savings for shortening the cycle. The cost-benefit analysis results indicated incremental industry cost of $550 million to move to T+2 while moving to T+1 would involve costs totaling $1.8 billion. Specific to buy side firms, the study indicated costs ranging from $0.3 million for small firms to approximately $1 million for large firms for moving to T+2 and $0.6 to $2 million in costs for moving to T+1.

Excluding the buy side, BGC's analysis indicated a payback period ranging from 2.1 to 2.6 years for a move to T+2 and from 3.0 to 3.7 years for moving to T+1. The payback period for the buy side is longer due to less incremental savings from operational and efficiency gains. For the buy side, the payback period is estimated at slightly over 5 years for a move to T+2 and nearly 11 years for moving to T+1. In the report BCG cites that the payback period for the buy side is significantly reduced when considering an estimate of risk reduction due to the shortened cycle. After accounting for the estimated benefit due to reduced loss exposure on in-process trades, the study estimates the buy side payback period to be less than 1 year for T+1 and T+2.

Conclusion

From their research BCG concludes that a transition to a settlement cycle of T+2 could be accomplished in approximately 3 years after a consensus for the move is achieved by industry stakeholders. If the industry decided to continue reducing the cycle, the research indicates that the move to T+1 could be achieved in approximately four to six additional years following the move to T+2. Finally, if the industry decided to move directly from the current T+3 cycle to a T+1 cycle, the BCG study suggests that the implementation would take approximately seven to eight years to complete.

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endnotes

[1] The full report is available on the DTCC website at: http://www.dtcc.com/downloads/leadership/whitepapers/BCG_2012.pdf

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