The Depository Trust & Clearing Corporation

SHORTENING THE SETTLEMENT CYCLE

MITIGATING SYSTEMIC RISK AND PROTECTING THE INTEGRITY OF THE U.S. FINANCIAL SYSTEM

The Depository Trust & Clearing Corporation (DTCC) recommends shortening the time period between trade execution and settlement of U.S. equities, municipal and corporate bonds, and unit investment trusts (UIT) from the current three-day settlement cycle (T+3) to a two-day settlement cycle (T+2). Shortening the time period between trade execution and settling payment for U.S. cash securities transactions protects the financial markets by reducing credit and liquidity risks for both the industry and the individual investor.

In the first half of 2014, the Investment Company Institute (ICI), the Association of Global Custodians (AGC), the Association of Institutional INVESTORS and the Securities Industry and Financial Markets Association (SIFMA) expressed support for a move to T+2 in a timeframe acceptable to the industry.

BACKGROUND

Currently, the securities industry completes settlement for equities, corporate and municipal bonds, and UITs on the third day after a trade is executed by sending payment for the trade to the seller and the securities to the buyer. This settlement cycle is known as "trade date plus three days" or T+3. The last time the U.S. settlement cycle was shortened was in 1995 when it changed from T+5 to T+3. Many countries already operate under a shortened settlement cycle. Europe is moving to T+2 in January 2015 and much of Asia already operates on a settlement cycle shorter than T+3.

CURRENT SETTLEMENT CYCLE – T+3

For Trades Executed by Brokers on US Trading Venues

T	T+1	T+2	T+3
The post-trade clearance and settlement cycle begins on the date the trade is executed. Trade details are electronically transmitted by participants to DTCC's subsidiary, National Securities Clearing Corporation (NSCC), for processing.	NSCC's guarantee of settlement generally begins midnight between T+1 and T+2. At this point, NSCC assumes the role of central counterparty, taking on the buyer's credit risk and the seller's delivery risk.	NSCC issues broker/dealers summaries of cleared trades, including information on the net positions of each security due or owed for settlement.	Settlement occurs on this day, with the delivery of securities to net buyers and payments of money to net sellers.

SETTING THE STAGE TO SHORTEN THE CYCLE

DTCC's recommendation is the result of an in-depth independent analysis of the challenges, benefits, and industry perspectives related to shortening the U.S. trade settlement cycle. As the backbone of the U.S. capital markets, DTCC is committed to protecting the industry and the markets by mitigating risks and creating efficiencies.

The industry previously considered a move to a shortened settlement cycle. In 2000, the Securities Industry Association (SIA), the predecessor to SIFMA, published a paper recommending a move to T+1 although the initiative was abandoned due to competing priorities. However, in the years since then, advancements in technology have made this a timely opportunity to revisit the benefits of shortening the settlement cycle.

In early 2012, DTCC socialized a paper entitled "Proposal to Launch a New Cost-Benefit Analysis on Shortening the Settlement Cycle" with regulators and SIFMA. The paper highlighted the risk mitigants and provided a status update on the ten building blocks necessary to reach a T+1 settlement cycle, as defined in 2000. The Boston Consulting Group (BCG) was retained in 2012 to conduct a cost-benefit study that examined the opportunities and challenges associated with shortening the settlement cycle. BCG estimated an industry cost of approximately $550 million to shorten the settlement cycle to T+2 and that such a move could be achieved within three years (provided no significant and/or conflicting demands on industry resources). DTCC believes that the cost associated with shortening the settlement cycle is outweighed by the significant benefits of risk reduction and improvements in operational efficiency that a shortened cycle provides the industry.

RISK BENEFITS

Shortening the settlement cycle will mitigate systemic risk by reducing exposure between the parties to a trade, between the counterparties to the clearinghouse, and for the clearinghouse itself.

For individual investors, shortening the settlement cycle will provide a greater sense of confidence in the safety of the U.S. equity markets and will enable quicker access to funds following trade execution. It will also allow the U.S. markets for equities, corporate and municipal bonds, and UITs to remain competitive with other markets around the world that have already moved, or are moving, to a shorter settlement cycle.

Additional benefits include:

- **Decline in Buy-Side Counterparty Exposure:** BCG analyzed the potential loss exposure the buy-side carries if a broker-dealer defaults. In stress tests, exposure reduced by 35% to 40% in a T+2 settlement cycle, as compared to the current T+3 environment.

- **Decline in Broker-to-Broker Counterparty Risk Measured by NSCC's Clearing Fund:** Broker-to-broker transactions are guaranteed to settle by DTCC's clearing agency subsidiary, NSCC. As a central counterparty (CCP), NSCC becomes the buyer to every seller and the seller to every buyer. In order to provide this guarantee, NSCC collects margin (clearing fund) to cover potential loss from a liquidation of a defaulting broker's open portfolio. The clearing fund NSCC collects represents the market risk NSCC carries for liquidating the portfolio. NSCC estimates that it would be able to reduce the amount its members contribute to the clearing fund by 15% to 24% in a T+2 settlement cycle subject to volume and volatility in the market.

- **Decline in Liquidity Needs:** As a central counterparty (CCP), NSCC is required under applicable regulations to have sufficient liquidity on hand to close-out the open guaranteed positions of the largest firm/family in the event that firm/family defaults. A 2011 study revealed that moving to a shortened settlement cycle would reduce NSCC's average liquidity needs by 20% in a T+2 settlement cycle. As DTCC looks to its member institutions to meet regulatory liquidity requirements, a reduced need for liquidity translates to savings for users.

- **Reducing Procyclical Collateral Calls:** A CCP should adopt stable and conservative margin requirements that are specifically designed to limit the need for destabilizing procyclical changes. In a shortened settlement cycle, the lower required deposits to NSCC's Clearing Fund would lessen potentially procyclical collateral calls on NSCC's members.

- **Reducing Market Risk:** Trades that have not yet settled are considered house trades or trades owned by the broker-dealer and do not become client trades until settlement completes. If a broker-dealer goes out of business prior to the settlement of certain trades, these open positions would be liquidated by NSCC to cover the counterparty's settlement. This means the end investor, be it a retail client or institutional investor, is subject to the risk of a broker-dealer default prior to settlement. By receiving their funds or securities faster and reducing their exposure to the broker-dealers, investors will face reduced risks especially in periods of stress.

- **Aligning Across Geographies:** Shortening the settlement cycle will align the U.S. with global standards as Europe moves to a T+2 settlement cycle in 2015 and much of Asia already settles on a cycle shorter than T+3. Harmonization across regions helps international funds better manage cash flows, which reduce and simplify financing needs.

- **Reducing Collateral Needs:** The reductions to NSCC's Clearing Fund deposits and to NSCC's liquidity needs reduce the collateral that firms provide to the clearing corporation. As new regulations are dramatically impacting firms' capital and collateral, this relief is especially important.

WHAT IS PROCYCLICALITY?

According to the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), procyclicality is defined as changes in risk management practices that are positively correlated with market, business, or credit cycle fluctuations and that may cause or exacerbate financial instability.

NEXT STEPS

As market participants and industry organizations collaborate on shortening the settlement cycle from T+3 to T+2, next steps include:

- Continuing to partner closely as a **steering committee and working parties** are formed as well as when decisions are made around approach and timelines.
- After T+2 is achieved, DTCC will work with the industry to **assess readiness for a further move to T+1**.

For more information, view DTCC Partners with the Industry to Implement T+2 in the U.S. at http://www.dtcc.com/en/news/2014/april/22/shortening-settlement-cycle.aspx.

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