22 January 2013

Reducing Risk by Strengthening Settlement

The Depository Trust Company, a DTCC subsidiary, is proposing major changes in the settlement of equities and debt securities to strengthen intraday settlement and reduce systemic risk. DTCC VP John Abel explains the proposed changes and what they mean to the markets.

The DTC, a subsidiary of The Depository Trust & Clearing Corp. (DTCC), is proposing major structural changes in the settlement of equities, corporate debt and municipal debt securities to reduce risk and strengthen intraday settlement finality in the US financial markets. DTC introduced the proposals in a white paper issued in December2012. The paper, A Roadmap for Promoting Intraday Settlement Finality in U.S. Markets, proposes implementing major settlement changes in the course of the next five years. DTCC VP John Abel explains the proposed changes and what they mean to the industry and the markets.

What prompted DTCC to consider making changes to the settlement process at this time?

We continuously monitor and review the DTC settlement processes and make adjustments as needed. But in light of our recent efforts to further reduce systemic risk, and in light of CPSS-IOSCO's recently issued new standards for financial market infrastructures, we've identified a number of significant enhancements to the US settlement process that will further improve the safety and soundness of the system for years to come while at the same time aligning the DTC settlement system closer to global standards.

Specifically, what changes or enhancements in the settlement process are you considering?

Basically we're looking at four targeted areas in the settlement process: The first is settlement matching; next we want to improve the way transactions from National Securities Clearing Corporation's (NSCC) Continuous Net Settlement (CNS) service are processed in DTC -- we're calling this CNS for Value. The third area is settlement processing for Money Market Instruments (MMIs), and lastly, we're looking at a shortened settlement cycle.

How is National Securities Clearing Corporation involved here?

National Securities Clearing Corporation – NSCC – is also a DTCC subsidiary; and with DTC, the two clear and settle virtually all financial instruments in the United States.

Can you discuss what you mean by settlement matching and how it will benefit the market?

Settlement Matching -- which is the global standard used in almost every other major Central Securities Depository (CSD) and International Central Securities Depository (ICSD) throughout the world -- will be introduced into DTC's settlement process. It will require receiving DTC participants to authorize or match transactions prior to DTC attempting to process these transactions. This will eliminate the need for reclamation transactions, or "reclaims," which will enhance intraday settlement finality, promote settlement certainty, and help eliminate credit and liquidity risk.

And CNS for Value? What will that do for the settlement process?

CNS for Value will seek to modify the way transactions resulting from NSCC's Continuous Net Settlement service are processed in DTC. With CNS for Value, CNS transactions will be processed as valued transactions in DTC instead of the current free-of-payment transactions. The proposed CNS for Value enhancement reduces DTC risk by eliminating the contagion risk that may occur when losses in DTC or NSCC spill over into each other. CNS for Value also provides our participants with greater efficiency of intraday liquidity and provides DTC and NSCC with better risk monitoring tools.

What are DTC's plans for MMIs settlement processing?

In 2012, DTCC, in collaboration with industry participants including the Securities Industry and Financial Markets Association (SIFMA), developed a model that will eliminate certain intraday reversals of transactions in DTC's MMI system. Under the current MMI settlement model, Issuing and Paying Agent (IPA) banks, which act on behalf of issuers, can instruct DTC to "refuse to pay" when the IPA has not received adequate funding from the issuer. In the event of a "refuse to pay," DTC will reverse all valued transactions processed for the designated issuer on the current day. MMI settlement reversals can create credit and liquidity risk and undermine intraday finality.

The new MMI settlement model will require changes to DTC's "refusal to pay" procedures and to current market practices. The proposed change will require confirmation that issuer funding has occurred before MMI transactions are submitted for processing. This, in effect, will eliminate the reversal of MMI transactions currently associated with a "refusal to pay."

What are DTC's recommendations on shortening the current settlement cycle?

The shortened settlement cycle is an ongoing industry initiative to analyze the business case for shortening the settlement cycle for US equity and corporate and municipal debt transactions from its current three days (T+3) to two days (T+2) or one day (T+1). Shortening the settlement cycle would reduce the market risk associated with trades between trade date and settlement date and would reduce a DTC customer's liquidity and capital requirements. DTCC commissioned a study on shortening the cycle last year and will discuss next steps with the industry early this year.

How will the totality of these changes affect the current settlement process?

The proposed changes will bring many benefits to the settlement process, primarily enhancing intraday settlement finality while substantially reducing systemic credit and liquidity risk for DTC and our participants. But it will also promote straight-through processing and better position DTC for a shorter settlement cycle, if and when that's recommended.

How long will it take to implement these changes, and how will DTC participants be affected?

These enhancements will likely require significant planning and development by DTC participants, which is why we plan to gradually implement the changes over the course of five years.

To access the DTC white paper, A Roadmap for Promoting Intraday Settlement Finality in U.S. Markets, visit http://www.dtcc.com/downloads/leadership/whitepapers/Settlement_White_Paper_Dec_10.pdf.