US mutual funds: Preparing for T+2

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The US mutual fund industry, which has used a three-day securities trade settlement (T+3) cycle since 1995, is preparing to join its European counterparts by shifting to two-day (T+2) settlement. The move, expected by the end of Q3 2017, promises substantial benefits to the industry and investors, but also poses a number of challenges and costs.

The change, which will force participants in US markets to perform in two working days the processes they currently conduct in three, has support from the Depository Trust & Clearing Corporation (DTCC) and industry organizations. These advocates expect the shorter settlement will not only effect operational efficiencies and reduce counterparty risk, but also align the US cycle with markets across the globe.

The industry clearly recognizes that inefficiencies, such as the lack of straight-through processing in client-side settlement, exist today. Furthermore, the continued issuance of physical certificates and prospectuses hampers efficiency, as does the ongoing lack of process harmonization across global markets and asset classes.

BENEFITS: NOW AND LATER

Two-day settlement will mitigate many of these inefficiencies, providing immediate benefits as the shorter settlement cycle reduces inherent trading risks by speeding trades from initiation to settlement. Credit and counterparty risk also will decline because a counterparty will be on the books for only two days instead of three. The faster access to funds will also help open further reinvestment opportunities.

Besides the more tangible benefits, the shorter settlement cycle also will reduce systemic risk by helping lower liquidity demands during high-volatility markets and improving coordination between global settlements. In fact, recent research from the Boston Consulting Group suggests the move could foster a 15% to 24% decrease in the average clearing fund requirement.

These benefits come at a cost, however. A 2012 BCG paper estimated the move to a T+2 environment would cost at least $550m in incremental investments alone and could run into the billions when factoring in systems upgrades and market processes.

EUROPE'S EXPERIENCE

We look to our European colleagues, many of whom implemented this change last October, for advice on how to prepare for the migration. They also can provide us with a more detailed understanding of the ways in which the move has proved beneficial.

Without automation of processes, together with same-day affirmation of trades, investment managers currently employing manual back-office processes will face challenges in a T+2 environment. Operations across time zones should also be an area of focus. For example, foreign exchange trades must be placed on trade date (T+0) within the same time zone of the associated securities trade to ensure delivery of the purchased currency without the need to borrow and manage incoming cash.

Industry collaboration is also essential. Industry participants need to agree on common processes that will apply over the settlement conversion period and beyond. This will ensure a uniform approach.

Fund assets such as equities, corporate bonds, unit investment trusts and municipal bonds will be most affected as final rules and implementation dates are published in Q2 2016, experiencing further effects when industrywide testing is finalized.

PREPARING FOR T+2

While the T+2 adoption date seems far off, now is the time for US funds to review their settlement procedures and identify any inefficiencies to ensure more orderly flow of securities transactions once T+2 takes effect.

To prepare for successful migration to T+2, we recommend that US funds: Plan sufficiently in advance; provide your partner with instructions as early as possible, ideally on T+0 (Trade Date); and automate your processes and settlement instructions.

In particular, parties should adequately prepare their liquidity requirements. These will be affected on the transition date, when there will be an exceptional settlement volume resulting from concurrent settlement of transactions executed on two separate trading days.

The move to T+2 no longer is a theoretical debate, but a market requirement. These advance efforts will help ensure that all market players work together to fully prepare for the inevitable migration. ■