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Securities settlement – T+1 comes into focus

The imminent launch by the Securities and Exchange Commission (SEC) of a T+1 settlement regime for US securities is set to reduce risk but also pose challenges – especially for market participants and regulators in other jurisdictions that, for the time being, retain a longer settlement cycle and may be forced to follow the US lead in due course.

Prompt settlement of securities transactions has always been an objective of market regulators, as well as being in the interests of market participants more broadly. The shorter the time between settlement and trade date, the less potential for things to go wrong.

Reflecting these desires for faster settlement, the settlement cycle – an involved, multi-stage process, requiring several intermediaries – has been on a path lower over time, enabled by technology. Major milestones to date in the US were the reduction from T+5 to T+3 under the Securities Exchange Act of 1934 and the further reduction from T+3 to T+2 in 2017. The launch of T+1 – the next major milestone to be implemented by the SEC – is scheduled for May 2024.

COVID-era settlement issues a key driver of T+1 initiative

The SEC's initiative was prompted in part by settlement issues that arose during the COVID-19 pandemic. The settlement process was frequently getting disrupted by, for example, chronic staff shortages at some of the intermediaries involved. As many of these are in far-flung parts of the world, keeping track of staff availability was a related challenge for financial institutions that needed trades settled over this period. These disruptions caused significant delays to the settlement process.

Importantly, these logjams exposed the extent to which the settlement process had lagged other areas of financial services in the push toward greater automation. They revealed that too much of the process was still being done manually given the availability of technology to automate it. This realization, along with the requisite additional technological and operational improvements, have helped to establish the necessary conditions for a T+1 cycle.

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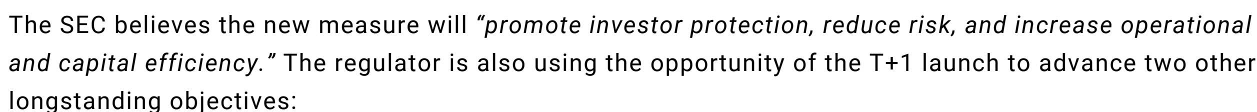

The SEC believes the new measure will *"promote investor protection, reduce risk, and increase operational and capital efficiency."* The regulator is also using the opportunity of the T+1 launch to advance two other longstanding objectives:

- New requirements for broker-dealers and investment advisors for the completion of trade allocations, confirmations, and affirmations on trade date (often referred to as "same-day affirmation")
- New requirements for central matching service providers (CMSPs) to promote straight-through processing (STP) of securities transactions

Benefits of new securities settlement regime

Market participants have for the most part reacted positively to the move, citing a range of benefits that include:

- Reductions to existing levels of risk to central clearing counterparties (CCPs) and market participants (including credit, market, and liquidity risk)
- Lower margin requirements
- Improved liquidity
- Improvements to post-trade processing

Retail investors, meanwhile, should benefit from:

- Increased certainty, safety, and security in the financial system
- Access to the proceeds, or purchases, of their securities transactions a day earlier
- The alignment of settlement cycles for ETF (currently T+2) and mutual fund (typically T+1) transactions

There is not too much to dispute regarding the proposed benefits of T+1 itself. In fact, according to the SEC, a large part of any pushback it received in response to its initial ruling was along the lines that T+1 doesn't go far enough, and that the target should be T+0.

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Concerns around mismatched settlement cycles

While the overwhelming consensus of market participants is that T+1 is a "good" thing, some have nonetheless raised concerns, both with the SEC and regulators elsewhere. These concerns relate predominantly to potential settlement mismatches with other jurisdictions that, for the time being at least, will retain T+2 or longer cycles.

These potential settlement mismatches are most likely to affect investment managers with holdings and service providers across multiple jurisdictions, including the US. These jurisdictions may be located in different time zones, with different market holidays and variations in cross-border settlement practices.

Time zone mismatches are likely to be a particular concern for investors in the Asia-Pacific region, for whom the significant time difference versus the US could mean they are effectively trading on a T+0 basis. While this will be less of a concern for Europe-based investors (as the overnight settlement process would at least still begin during the US working day), settlement will still need to be completed in a significantly shorter timeframe.

Meeting T+1 deadlines for US security purchases will also place additional strain on funds' cash management processes. Overnight (T+1) settlement means that funds purchasing securities will also need to have the cash in place to pay for the securities at shorter notice. This could be particularly difficult for large funds, which might require short-term borrowing. The trouble is there are typically restrictions on how much funds can borrow. European UCITS funds, for example, are prohibited from borrowing more than 10 percent of their net asset value. Any additional foreign exchange transactions that might be required to pay for securities will place further pressure on liquidity and cash management.

Global coordination

These factors increase the risk of not meeting the imminent T+1 requirement, potentially resulting in failed trades. To avert this outcome, a higher level of global coordination and harmonization of settlement cycles is required, according to those who voiced concerns.

Regulators and supervisory bodies outside the US have been sounding out market participants on the prospects of following the US lead, and indeed moving to T+0. For example, the European Securities and Markets Authority (ESMA) has issued a call for evidence to gather stakeholders' views on:

- The potential impacts of changing EU settlement cycles
- The costs and benefits of shorter settlement cycles in the EU
- How and when shorter settlement cycles could feasibly be imposed in the EU
- The impact on the EU's capital markets of international changes to settlement regimes

In the meantime – and in advance of the May deadline – those administering funds with exposure to US securities are submitting their plans for approval to various central banks, and other relevant bodies, around the world.

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- Life of a Trade – An Introduction
- Life of a Trade – Clearing & Settlement
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- Credit Risk – An Introduction
- Credit Risk – Types
- Liquidity Risk – An Introduction
- ETFs – An Introduction
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Navigating inflation: Soft landing on a moving target

Amid strong signs that the aggressive tightening cycle implemented by monetary authorities to combat inflation may have run its course – with interest rates set to head lower later this year – markets are jubilant. However, some central bankers and economists caution that these celebrations may be premature.

2023 was supposed to be the year that saw a widely expected recession in the US become a reality. Instead, the US economy confounded the consensus by recording the fastest growth of any major economy. Its labor market showed remarkable resilience, with unemployment staying close to cycle lows and wages increasing. Meanwhile, inflation fell sharply in the second half of the year, despite the strong wage data, edging gradually toward the Fed's 2% target. This combination of wage growth with falling inflation translated to productivity gains in the latter half of the year that weren't on anyone's list of 2023 surprises (let alone expectations).

Fed Chairman Jay Powell appeared to signal a major policy turning point during the post-Federal Open Market Committee (FOMC) press conference in mid-December. Given the persistent decline in inflation toward the 2% target, Powell said that he saw grounds for a sustained reduction in interest rates from their current level of 5.25–5.5%.

Chair of the Federal Reserve, Jeremy Powell (CNBC)

Powell's comments took markets by surprise, causing a sharp rally in both bonds and stocks that lasted through the end of the year. The significance of his comments, or the surprise – and probably what caused markets to rally as hard as they did – was that they effectively signaled the abandonment of the "higher for longer" outlook that had dominated over the past couple of years. Economic hardship would no longer be required for a reduction in rates. Lower inflation would be enough. The bar for rate cuts was therefore lowered.

Markets kicked off 2024 in buoyant mood, carried by the December momentum and pricing in six rate cuts in the US this year alone. More recent developments, however, have tested this newfound optimism. The latest inflation figures in the US – the December CPI – came in "hot" at 3.4% (compared with 3.1% in November), reigniting fears in some corners of more secular inflation pressures that will be hard to tame. Had the markets overshot in terms of pricing in a soft landing?

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Markets ahead of monetary authorities

The markets appeared to have gotten ahead of the FOMC's expected trajectory of rate cuts, reflected in recent comments from FOMC members. Policymakers elsewhere have also pushed back against some of these rosy expectations. In Europe, the World Economic Forum in Davos kicked off with ECB President Christine Lagarde warning against market assumptions of early rate cuts. Hot on the heels of these comments, UK inflation figures for December showed an increase (over the prior month's reading) for the first time in ten months.

Origins of inflation

The speed of any rate cuts is conditional on an array of economic factors and will require delicate judgment. It also depends largely on the nature and origins of this latest wave of inflation, which has become a hotly debated topic among economists. Two competing schools of thought have emerged on this.

"Team Transitory"

At one extreme are those economists who believe inflation was always going to be a transitory problem. By extension, they see a soft landing as the most plausible scenario. This group has come to be known as "Team Transitory" (much to the dismay of many economists – including members and sympathizers – who balk at this oversimplification).

Their view can be roughly summed up as follows: The wave of inflation that took hold in late 2021 was driven by supply shortages (cost-push inflation), not demand (demand-pull inflation). The origins of the inflation shock were unique – primarily the COVID-19 pandemic and the supply chain disruptions it caused. Inflation was then further exacerbated by another unique event in February 2022 when Russia invaded Ukraine, sending shockwaves through crucial energy and food markets. This too was clearly a supply-side shock.

Citing the unique origins of this inflation, some of these economists have challenged economic orthodoxy regarding the appropriate cure. If supply was the problem, rather than demand, monetary policy tightening – which aims to bring down inflation by suppressing demand – was the wrong tool. It would do nothing to alleviate the supply disruptions caused by COVID and President Putin's invasion of Ukraine. Policymakers should instead have implemented measures that would have boosted supply through increased investment. Any fears that such spending might instead stoke inflation are unfounded, in their view.

"Team Permanent"

At the other end of the spectrum are those who believe inflation may be here to stay – or "Team Permanent" (also an unwelcome oversimplification for many economists.)

These more “traditional” economists don’t dispute the role that supply factors played in causing the inflation spike. However, they assign greater significance (than Team Transitory does) to the role that the COVID response (by governments and central banks) played. The extraordinary measures – particularly the fiscal handouts that put money straight into consumers’ pockets – overstimulated demand. Inflation, according to this interpretation, was therefore primarily a demand problem. And the remedy was “traditional” monetary tightening, exactly as central banks did.

The traditionalists worry generally about the fiscal profligacy of the US government (and others), reflected in a fiscal deficit of around 7% (unprecedented ex-recessions). The rampant spending shows no signs of abating. This, they believe, is both unsustainable and testament to populism (on both sides of the “aisle”) that has become increasingly entrenched. It is also hostile to monetary policymakers’ attempts to bring inflation lower and keep it down.

Who’s “winning?”

On the face of it, soft landing advocates (Team Transitory) may appear to have the upper hand in the debate. After all, inflation has come down meaningfully, despite continued government spending and rising deficits. Recession has not only been averted, but has not even looked like a remote threat, at least not in the US. The markets agree and a soft landing is now the consensus view.

However, the traditionalists (Team Permanent) can point to the success of the latest round of tightening in bringing down inflation as evidence that the tried-and-tested measures do work. From their perspective, any “victory laps” by Team Transitory are not only premature, but disingenuous, as the reason for the inflation reduction that they are cheering is the aggressive monetary tightening in 2022 – precisely the sort of hard measures that the traditionalists would have prescribed (but that Team Transitory was dead against).

Outlook

Allowing for differences in opinion within the group, the scenario seen as most plausible for Team Transitory is that inflation continues lower and reaches 2% soon. At this level, real interest rates would now be standing at around 3% (using a crude measure of current policy rates less inflation), which means they have plenty of room to go lower. Both equity and bond markets should perform decently in this scenario. Monetary authorities have little to fear from lowering interest rates, and this will not cause a resurgence of inflation. Instead, the key risk they see is that the Fed and other central banks – fearing a return of inflation or for whatever other reason – do not cut rates enough.

The Team Permanent camp (also allowing for divergent views within) believes that cuts to interest rates will not happen in a vacuum. Just as monetary tightening succeeded in bringing down inflation by suppressing demand, monetary loosening will stimulate demand. The main risk then, from their perspective, is that loose monetary conditions cause inflation to come roaring back, supported by an inflation-friendly backdrop of those more permanent features of our current world (reshoring, populism, and so on).

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Reconciling these views

Recent comments by Fed Governor Christopher Waller provide some reconciliation of these extremes. He said the US was “within striking distance” of the 2% target. However, the Fed should proceed more cautiously than in previous cutting cycles that were in response to economic shocks. The comments would appear to suggest that anyone expecting rapid cuts is likely to be disappointed.

In a subsequent interview, Waller was asked about the role fiscal policy (in other words, demand) had played in causing the inflation the Fed has been fighting. While acknowledging the supply factors, Waller threw quite a large bone to the traditionalists. Let’s conclude by quoting his reply in full:

“Well, just from a simple macroeconomics point of view, if you’re going to increase the spending in the debt by $6 trillion in a matter of two years, and then say that has no effect on demand – that seems just impossible to me. It isn’t the only thing that contributed to inflation, but it certainly has had to have had an impact. The reason I say that is people have been talking a lot about, ‘Oh, all the last six months shows this was all supply, all supply, all supply.’ Well, if these are temporary supply shocks, when they unwind, the price level should go back down to where it was. It’s not. Go to FRED. Pull up CPI. Take the log. Look at that thing. The [price level] is permanently higher. That doesn’t happen with supply shocks. That comes from demand. And this was a permanent increase in demand and permanent increase in debt.”

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- Financial Authorities (US) – Federal Reserve
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- Economic Indicators – An Introduction
- Inflation – An Introduction
- Inflation Indicators
- Fiscal Policy Analysis