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How far will the JGB settlement cycle ultimately be shortened?

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The JGB settlement cycle for outright transactions will be shortened to T+2 from April. The JSDA has set a target of ultimately moving to T+1 settlement, but many issues remain to be resolved before T+1 becomes reality. Continued discussion and educational activities are needed.

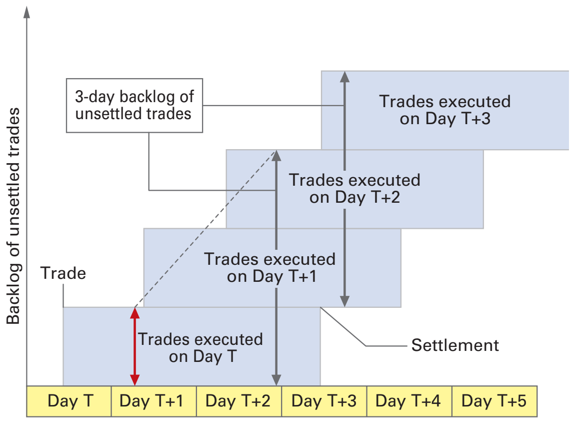
Industry-wide initiative to reduce JGB settlement risk

Much progress has been made in reducing settlement risk in the JGB market since Lehman Brothers' September 2008 collapse. The Lehman debacle triggered ¥7 trillion in defaults in September 2008 alone, according to the BOJ's Payment and Settlement Systems Department. Counterparties were forced to replace positions (repurchase JGBs slated to be delivered by Lehman or resell JGBs that had been slated to be delivered to Lehman) but were unable to do so quickly enough to avoid a ¥6 trillion chain reaction of settlement fails (past-due deliveries) in September 2008.

In response to these events, the Financial Services Agency published a paper entitled Development of Institutional Frameworks Pertaining to Financial and Capital Markets on January 22, 2010. In it, the FSA recommended shortening the JGB settlement cycle and establishing and widely implementing rules for dealing with settlement fails[1]. It is generally said that if the settlement cycle for outright purchases and sales of JGBs is shortened from its current three-day duration (T+3) to one day (T+1), the backlog of unsettled trades (i.e., the amount of settlement risk) would be reduced by two-thirds (Exhibit 1).

Exhibit.1 **Benefit of shortening the settlement cycle**

Shortening the settlement cycle from T+3 to T+1 would reduce risk by two-thirds



Source: Presentation by Reitaku University Professor Masashi Nakajima at NRI-sponsored Securities Settlement System Reform 2014 seminar (November 18, 2011)

In major American and European countries, outright transactions in government bonds typically settle the next day (T+1) or on the second day (T+2). In Japan, the corresponding settlement cycle is long by comparison (Exhibit 2). General collateral (GC) repurchase (repo) transactions[2], which are used to finance outright purchases of JGBs, require a settlement cycle one day shorter than outright transactions' settlement cycle.

Exhibit.2 **Outright-transaction settlement cycles in major countries**

	US	UK	Germany	Hong Kong	Japan
Gov't bonds (repos)	T+1 (T+0)	T+1 (T+0)	T+2 (T+1)	T+1 (T+0)	T+3 (T+2)

Source: Presentation by Reitaku University Professor Masashi Nakajima at NRI-sponsored Securities Settlement System Reform 2014 seminar (November 18, 2011)

Given the need for consensus among market participants and market infrastructure providers to shorten the JGB settlement cycle, the Japan Securities Dealers Association established a Working Group on Shortening of JGB Settlement Cycle in September 2009. The working group issued its final report on November 30, 2011.

The report presents a plan to shorten the JGB settlement cycle in two phases. First, the settlement cycle for outright transactions would be shortened to T+2 (T+1 for GC repo trades) effective from April 23, 2012. In the second phase, it would be shortened to T+1 (T+0 for GC repo trades) by a target date of 2017 or soon thereafter. The Working Group plans to resume planning the transition to phase two in the second half of fiscal 2012.

Existing systems can accommodate T+2 settlement of outright transactions

The phase-one transition to T+2 settlement of outright transactions will require electronic automation (speeding-up) of trade matching and bilateral netting processes, but this can be accomplished without imposing much additional costs on market participants or market infrastructure providers by making greater use of straight-through processing while basically maintaining the status quo.

The shortened JGB settlement cycle will not apply to small retail transactions or nonresidents' transactions for which T+2 settlement would not be practicable. The working group decided to exclude such transactions from the shortened settlement cycle after determining that doing so would not adversely affect management of funds or JGB positions.

High hurdle to realization of T+1 settlement of outright transactions

However, in terms of the challenges posed by a shorter settlement cycle, the phase-two transition to T+1 settlement of outright transactions decisively differs from phase one in the following two respects.

(1) Limitations of existing workflow and market infrastructure

When the settlement cycle for outright transactions is shortened to T+2, there will still be a minimum of one business day between the trade and settlement dates, enabling trades to be settled with market participants and market infrastructure providers' existing back-office processes and systems (e.g., overnight batch-processing systems). With T+1 settlement, however, most post-trade processing will have to be done on the date of the trade. Upgrading existing systems to real-time processing systems will entail considerable time and expense.

(2) Differences in market participants' trade motivations

Securities dealers often use GC repos to fund outright purchases of JGBs. They will consequently need the standard GC repo settlement cycle be shortened to T+0 to accommodate T+1 settlement of outright transactions.

In contrast, the investors that are the securities dealers' GC repo counterparties enter into repos to earn a return on short-term funds. They are averse to the increased risk of settlement fails and the investment in back-office infrastructure that transition to T+0 settlement of GC repos would entail. Institutional and market infrastructure that meet the needs of both securities dealers and investors will have to be designed and put into place.

Issues such as these cannot be resolved by merely upgrading existing systems. They require much discussion of legal aspects (e.g., standard repo contracts) and issues such as establishment and operation of GC repo collateral management services, revision of customary market practices, and handling of nonresidents' transactions.

The securities settlement system reforms of 2000–09 that culminated in dematerialization of stock certificates had obvious benefits as a sort of national project. The newly proposed reforms' intended benefits from reduction of settlement risk and international standardization are less apparent, according to some financial institutions that will directly bear the cost of back-office process modifications and system upgrades.

However, reduction of the backlog of unsettled JGB trades will lessen risk throughout Japanese financial markets as discussed above. Transition to T+1 settlement of outright transactions should be framed as a restructuring to establish low-risk, highly efficient market infrastructure and practices. Regulatory authorities and market infrastructure providers should broadly engage market participants in discussions and educational activities regarding the settlement-system reforms' significance and continue to endeavor to fulfill their accountability to end-investors for indirect costs vis-à-vis risk reduction.

Note

1) As a result, fail charges were instituted from November 2010. A fail charge is a monetary penalty paid to counterparties by parties that have failed to deliver JGBs by the scheduled settlement date.

2) GC repos are financing transactions collateralized by debt securities that need not be one specific issue and can be substituted mid-transaction.

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