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lakyara vol.212

Japan moving ahead with migration to T + 1 settlement of JGB trades to strengthen its international competitiveness

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10. March. 2015

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Executive Summary

Market participants and infrastructure providers will soon agree on a target date for migration to T + 1 settlement of JGB trades. Both must upgrade their systems to accommodate a shorter settlement cycle in the aim of not only reducing settlement risk but also strengthening Japanese financial markets' international competitiveness.

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Grand Design unveiled

On November 26, 2014, the Japan Securities Dealers Association's (JSDA) Working Group on Shortening of JGB Settlement Cycle unveiled a "Grand Design" for shortening the JGB settlement cycle to one business day (T + 1). In the wake of the Grand Design's publication, market participants have increasingly been getting involved in the discussion of migration to T + 1 settlement, which had previously been confined mainly to the JSDA's Working Group.

Migration to T + 1 settlement of JGB trades is an initiative to reduce JGB settlement risk in response to Lehman Brothers' September 2008 bankruptcy. The Lehman bankruptcy reportedly triggered ¥7 trillion in defaults and a ¥6 trillion chain reaction of settlement fails (past-due deliveries)[1]. In response, the Financial Services Agency sought to shorten the JGB settlement cycle as one way to reduce settlement risk. The JSDA consequently established its Working Group in September 2009.

In November 2011, the JSDA Working Group released its final report on shortening the JGB settlement cycle. In accord with its final report's recommendations, the settlement cycle was shortened to two business days (T + 2) for outright JGB transactions and SC repos[2] and one business day (T + 1) for GC repos[3] effective from April 2012. Additionally, a broad cross-section of market participants have been discussing infrastructural and procedural requirements for realizing T + 1 settlement of outright transactions and SC repos (and same-day (T + 0) settlement of GC repos) in 2017 or as soon as possible thereafter. Against such a backdrop, the JSDA Working Group formulated and released its Grand Design to help market participants gain an overall understanding of T + 1 settlement and enable them to expeditiously formulate their own plans for migrating to a T + 1 settlement cycle and to ascertain the costs of doing so.

NOTE

1) According to the BOJ's Payment and Settlement Systems Department.

2) SC repos (special collateral repurchase transactions) are securities lending transactions in which the borrower specifies a specific security issue to be borrowed. SC repos are generally not entered into for financing purposes.

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

Overview of migration to T + 1 settlement

The JSDA Working Group's Grand Design for migration to T + 1 settlement comprises the following three main steps.

(1) Adoption of new form of repo in aim of further globalizing JGB market

One objective of migrating to T + 1 settlement is to maintain and strengthen Japanese financial markets' international competitiveness. In light of this objective, the Grand Design seeks to harmonize repo contracts used in Japan with those used overseas and in cross-border transactions. Specifically, the new repos will be structured as conditional purchases/sales instead of as cash-collateralized securities lending transactions, currently the repo structure most widely used in Japan.

(2) Migration to T + 1 settlement of outright JGB transactions and SC repos

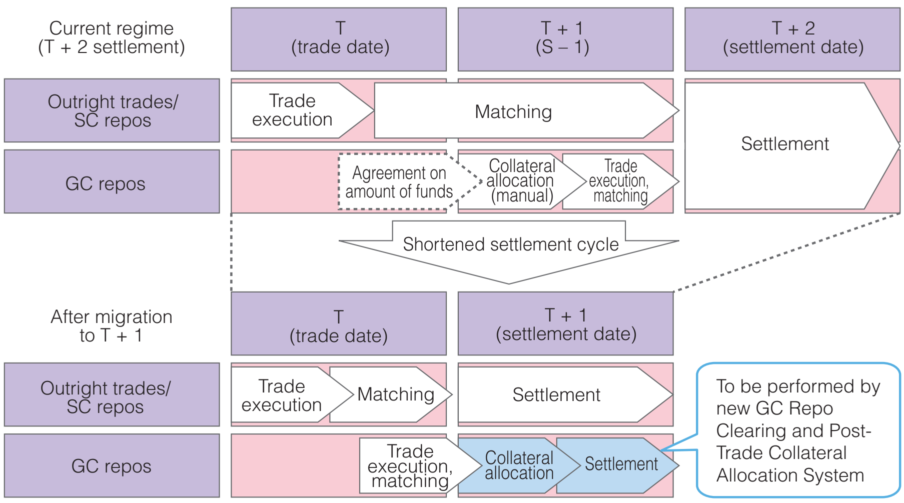
The JSDA Working Group will formulate a universal schedule to enable market participants to complete post-trade processing (excluding settlement) on the trade date. Based on this schedule, it will promote standardized data formats and electronic data interchange for all processing from trade execution through settlement. Additionally, it will promote installation and utilization of market infrastructure to facilitate STP[4] (straight through processing) by market participants, including those with small transaction volumes.

4) STP is seamless electronic processing of securities transactions from trade execution through settlement. Once inputted into an STP system, trade data need not be inputted again.

(3) Migration to T + 0 settlement of GC repos

To shorten the post-trade processing cycle for GC repos to T + 0 settlement, post-

Exhibit. Migration to T + 0 settlement of GC repos with post-trade collateral allocation



Source: NRI, based on JSDA's Grand Design for Shortening of JGB Settlement Cycle (T + 1) trade collateral allocation will be used for GC repos in Japan like in the US and UK. With post-trade collateral allocation, only the amount of funds to be borrowed and a list (basket) of securities eligible to be pledged as collateral is specified at the time of the trade. Immediately before settlement, collateral is allocated from the repo seller's then-available JGB inventory, taking into account any changes therein resulting from other JGB trades that have settled in the interim. To lessen market participants' administrative burden with respect to post-trade collateral allocation, a GC Repo Clearing and Post-Trade Collateral Allocation System will be developed utilizing existing market infrastructure.

Market participants' migration to T + 1 settlement

To realize the above three steps in practice, market participants will have to upgrade their systems as follows.

(1) Real-time processing

In the current T + 2 settlement cycle, batch processing systems are adequate for processing JGB trades. Once the settlement cycle is shortened by one business day to T + 1 (T + 0 for GC repos), post-trade processing must take place in real time from inception through settlement. IT systems differ widely among financial subsectors and individual financial institutions, but many financial institutions are still using batch processing for their core and/or account systems. Upgrading to real-time processing will be a major undertaking for such market participants.

(2) System automation

Exception handling must be minimized in all processing steps from trade execution and matching through clearing and settlement. Under the existing T + 2 regime, post-trade processing can be accomplished with minimal STP, but migration to T + 1 (T + 0 for GC repos) will require various in-house system upgrades such as automation of trade netting and more extensive STP of front-office matching and back-office trade confirmation and matching, although required upgrades will differ among financial institutions depending on the specific nature of their business, transaction volume and other such factors.

(3) Augmentation of monitoring functions

As post-trade processing is further automated, detecting and promptly rectifying problems will be crucial tasks. In other words, monitoring functions must be improved in matching, settlement, position management and other processes. Additionally, all processes will require unified monitoring of whether exceptions are being handled properly.

(4) Transition to new settlement regime

Market participants will have to develop functional upgrades to transition to T + 0 settlement of GC repos with post-trade collateral allocation and accommodate the aforementioned new repo contracts.

As explained above, migration to T + 1 settlement of JGB trades will involve initiatives aimed at strengthening Japanese financial markets' international competitiveness, including adoption of a new contract that conforms to global standards. By spring 2015, the JSDA Working Group aims to reach a consensus with market participants regarding a target date for switching to T + 1 settlement. Although the transition will entail substantial changes in existing business processes and practices, market participants must broad-mindedly play their part to upgrade securities settlement in Japan.

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