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JGB trade settlement: aiming for global standard of T+1

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Executive Summary

The JGB trade settlement cycle was shortened to T+2 effective from April 23, 2012. In October 2012, a securities industry working group began to work toward the ultimate goal of T+1, the global standard. Reaching this goal will entail substantial costs, which are the biggest concern. Realization of T+1 will require a cross-industry approach based on recognition of the significance of T+1 relative to the cost.

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First stage of JGB settlement risk reduction completed

Much progress has been made in reducing JGB settlement risk since Lehman Brothers' September 2008 collapse. According to the BOJ's Payment and Settlement Systems Department, the Lehman debacle triggered ¥7 trillion in defaults and a ¥6 trillion chain reaction of settlement fails (past-due deliveries). In responses, the Financial Services Agency (FSA) sought to shorten the JGB settlement cycle as one means of reducing settlement risk[1].

Given the need for consensus among market participants and market infrastructure providers to shorten the JGB settlement cycle, the Japan Securities Dealers Association (JSDA) established a Working Group on Shortening of JGB Settlement Cycle in September 2009. The working group's final report, issued on November 30, 2011, presented a plan to shorten the JGB settlement cycle in two phases. In the first phase, the settlement cycle was shortened to two days (T+2) for outright transactions and one day (T+1) for GC repo[2] trades effective from April 23, 2012. GC repo transactions are used to finance outright purchases of JGBs and therefore require a one-day-shorter settlement cycle than outright transactions.

The first phase's T+2 settlement of outright transactions requires electronic automation (speeding-up) of trade matching and bilateral netting processes. This was achieved by making greater use of straight-through processing while basically maintaining the status quo, thereby largely sparing market participants and market infrastructure providers from additional costs. The transition to T+2 consequently proceeded smoothly, except for initial system glitches experienced by some online services. It also resulted in improved processing efficiency due to standardization of data formats.

NOTE

1) In a paper entitled Development of Institutional Frameworks Pertaining to Financial and Capital Markets (published January 22, 2010), the FSA recommended shortening the JGB settlement cycle and establishing and widely implementing rules for dealing with settlement fails as measures to reduce settlement risk. 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 (general collateral repurchase transactions) are financing transactions collateralized by debt securities that need not be one specific issue and can be substituted mid-transaction.

Challenges posed by shortening JGB settlement cycle to T+1

In the second phase, the settlement cycle for outright transactions is to be shortened to T+1 (T+0 for GC repo trades) by 2017 at the earliest. The long lead time reflects the phase-two process faces the following two challenges.

(1) Limitations of existing workflow and market infrastructure

With T+2 settlement of outright transactions, there is always at least one full business day between the trade and settlement dates. A T+2 settlement cycle thus provides enough time for market participants and infrastructure providers to settle trades with their 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 trade date. Upgrading existing systems to real-time processing 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. Shortening the settlement cycle for outright trades to T+1 will consequently increase the need for the standard GC repo settlement cycle be shortened to T+0. Meanwhile, the securities dealers' GC repo counterparties are investors seeking to earn a return on short-term cash balances. They are averse to the increased risk of settlement fails and the investment in back-office infrastructure that would be entailed by transition to T+0 settlement of GC repos. Further shortening of the JGB settlement cycle would therefore require institutional and market infrastructure that meets the needs of both securities dealers and investors to be designed and put into place.

A T+1 world is completely different from existing framework. The two challenges cited above cannot be surmounted by extending existing processes. They cannot be resolved without discussion of many matters, including legalities (e.g., standard repo contracts), modification of customary market practices, handling of nonresidents' transactions, and establishment and operation of GC repo collateral management services.

Aiming for globalization of JGB settlement infrastructure

The transition to T+1 will clearly be much more costly than the switch to T+2 was. Some observers warn that the switch to T+1 is unlikely to be cost-beneficial for small and mid-tier players not heavily represented within the JSDA Working Group, which is made up predominantly of major players.

From a global perspective, however, transition to T+1 is essential. Although JGB issuance is now mostly absorbed domestically, from a fiscal management standpoint it will be imperative for the Japanese government to diversify its funding sources by broadly attracting overseas investors. Nonresidents' low level of JGB ownership is attributed to various factors, but globalization of JGB settlement infrastructure is a prerequisite for JGBs to become a global product. Among other major countries, outright government bond trades are already being settled on a T+1 basis (T+0 for GC repos) in the US, UK and Hong Kong. Even though Japan switched to T+2 settlement of outright JGB trades from April 2012, its government bond settlement cycle is still longer than these other countries'.

Japan's settlement infrastructure is also starting to evolve in response to globalization. The BOJ plans to launch a new financial network system (BOJ-NET[3]) in early 2016. The BOJ-NET will be on-line nearly 24 hours a day. Additionally, the Japan Securities Depository Center (JASDEC) will upgrade its systems into compliance with the ISO[4] 20022 international standard for financial services messaging[5]. JASDEC will be one of the first global securities clearinghouses with ISO 20022-compliant infrastructure. Transition to T+1 settlement of outright JGB trades can be regarded as part and parcel of this trend toward globalization of Japanese financial markets. With a national initiative underway to globalize securities settlement, if transition to T+1 settlement of outright JGB trades is delayed due to individual financial institutions' cost-benefit considerations, such a delay would be a major loss in terms of Japanese financial markets' development.

3) The new BOJ-NET will incorporate the latest information processing technologies. It is slated to be highly adaptable to change and highly convenient to access. The BOJ plans to develop and install the new BOJ-NET by a target date of 2015.

4) International Organization for Standardization

5) In response to the trend toward international standardization of trading and settlement systems in the wake of foreign investors and global players' growing presence and a growing need for foreign clearinghouses' direct involvement, JASDEC aims to upgrade to ISO 20022-compliant systems by January 2014.

The JSDA Working Group has reconvened and started working on the transition to T+1 from October 2012. To resolve the challenges discussed above, it plans to work on two major projects in parallel.

a) Transaction procedures and infrastructure for T+0 settlement of GC repos[6]

(1) Transaction procedures are mainly front-office matters. Issues that the Working Group plans to address, in coordination with the Bond Repo Research Group, include contract terms, trading hours, legal framework, and other such matters.

(2) Infrastructure (collateral management infrastructure) mainly involves back-office functions. The Working Group plans to work together with the Japan Government Bond Clearing Corporation and JASDEC to decide how market infrastructure

6) To be handled by two subgroups of the Working Group.

should function in terms of trade matching, novation, clearing, and settlement. Other infrastructure-related matters on its agenda include procedures for and timing of confirmation of allocable collateral balances.

b) Grand design of post-T+1 JGB market[7)]

The Working Group will conduct research and identify issues through such means as interview surveys of a broad range of market participants and occasionally issue informational updates and progress reports on its work.

7) To be handled mainly by the Working Group's Secretariat.

Regulatory authorities and market infrastructure providers need to realize that the transition to T+1 is their last chance to establish low-risk, highly efficient market practices and infrastructure. While seeking broad input from market participants, they must endeavor to jointly develop IT systems to reduce system costs, the biggest barrier to T+1. Meanwhile, they should also continue to conduct educational activities to be accountable to end-investors in terms of indirect costs relative to risk reduction.

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