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Utility services' significance for T+1 settlement of JGB trades

Shigenobu Kimura

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Executive Summary



Shigenobu Kimura

General Manager

NRI Process Innovation, Ltd.
Prime Settlement Service
Department

NOTE

- 1) SC repos are transactions whereby the buyer borrows a specific bond issue against cash collateral.
- 2) GC repos are transactions whereby the seller borrows funds against securities pledged as collateral. The collateral may consist of any eligible securities issues.
- 3) JSSC is a centralized securities clearinghouse in Japan.

JGB market participants have been ramping up preparations to migrate to a T+1 JGB settlement cycle, the biggest change to Japan's securities market plumbing in recent years. Operating models that utilize utility services are emerging as a means of maintaining competitiveness.

In 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). The Grand Design entails two major changes: (1) shortening the settlement cycle for outright JGB trades and SC (special collateral) repo trades¹⁾ to T+1 (i.e., settlement on the first business day after the trade date) from T+2 at present and (2) adopting post-trade collateral allocation for GC (general collateral) repo trades²⁾ in conjunction with migration to T+0 settlement of GC repo trades.

For GC repo trades, Japan Securities Clearing Corporation (JSSC)³⁾ will handle the post-trade collateral allocation function and, together with the JSDA, set market rules and help to reduce market participants' back-office workloads. Post-trade collateral allocation is scheduled to begin from May 2018. With the JSDA recently announcing plans to conduct comprehensive system testing beforehand, market participants are set to finally begin redesigning their workflows and upgrading their IT systems in preparation for the market tests.

Challenges posed by T+1 JGB settlement cycle

Migration to a T+1 JGB settlement cycle is of course no easy feat for the parties involved. The process involves many different tasks, including contract revisions, workflow redesigns, IT system upgrades and project management. Challenges that need to be addressed from a settlement workflow standpoint include the following three in particular.

(1) Shorter post-trade processing time

The biggest concern in terms of migration to T+1 is that most post-trade processing must be completed on the trade date. Workflows that have hitherto spanned two business days, including those for confirming trades, resolving mismatches, funding, accounting, handling exceptions and reporting, will have

4) F2B refers to the teams involved in the trade cycle from trade execution by the front office until settlement has been completed by the back office.

to be revamped on a front-to-back (F2B⁴⁾) basis and utilize straight-through processing (STP) more extensively so they can be completed on the trade date. Otherwise, stable system operation may not be possible.

(2) Increased workload during settlement hours

The new settlement flow for GC repos with post-trade collateral allocation will have three settlement deadlines daily⁵⁾. Trades' settlement status must be constantly monitored throughout the morning to prevent settlement fails, likely leading to an increase in back-office workload during the morning hours. In addition to IT system modifications needed to process data in parallel with the JSSC and Bank of Japan, back offices will require peak-time capacity controls and operations staffing sufficient to actually perform settlement functions.

5) The DVP (delivery versus payment) settlement deadlines are 10:30, 13:30 and 15:30 for delivery of securities and 11:00, 14:00 and 16:00 for funding. The corresponding deadlines for notification of deliverable JGB positions are 21:00 on the evening preceding the settlement date and 11:00 and 14:00 on the settlement date. In other words, such notifications based on accurate monitoring of positions must be made during peak settlement hours.

(3) Accurate position management on F2B basis

With post-trade collateral allocation, GC repo parties must notify the JSSC of deliverable GC-eligible JGB holdings after the trade has been executed. They need to accurately keep track of their positions in these deliverable JGB issues on an F2B basis and in real time lest, for example, the back-office staff, uninformed of an executed T+0 trade scheduled to settle on the same day, includes the same bonds in its database of positions in deliverable issues. If unable to accurately manage positions, parties to GC repo trades would be at risk of settlement fails and could incur costs to purchase or borrow bonds to settle trades. Such an outcome would be contrary to the T+1 settlement cycle's intended purpose of reducing settlement risk. While management of deliverable positions in GC-eligible bonds might be somewhat amenable to a rules-based approach, it will likely entail an unprecedented level of communication between the front and back offices and therefore require advance preparation.

In addition to these three challenges, repo market participants likely face many company-specific issues that they need to expeditiously resolve with respect to their own operating procedures and IT systems.

Utility services as a solution

With such major reforms, ensuring an efficient transition and stable IT system operations is essential, but doing so entirely with in-house resources is prohibitively costly for many financial institutions under pressure to cut costs. Attempting to reduce back-office costs through the conventional approach of simply outsourcing to an overseas subsidiary poses risk to business process quality⁶⁾.

6) Challenges often encountered in outsourcing to an overseas subsidiary include limited availability of personnel with Japanese language capabilities, difficulty of training personnel in complex business processes and high employee turnover.

7) Utility services combine business process outsourcing (BPO) and IT outsourcing (ITO) to provide standardized services to multiple financial institutions.

In response to such risk and cost considerations, utility services are emerging as a global trend. Utility services typically standardize business processes that need not be differentiated from other companies' and automate them with IT⁷⁾. The business processes are standardized by reengineering them and adjusting their scope. In addition to long-term operating cost savings, utility services' advantages over conventional outsourcing include the following.

(1) Business process quality

To maintain business process quality, financial institutions have hitherto been recruiting and training qualified personnel and improving their workflows themselves. Utility services enable them to maintain back-office business processes' quality through a service level agreement (SLA) with the utility service vendor⁸⁾. The vendor assumes responsibility for ensuring service quality at the level specified in the SLA. At the same time, this arrangement enables financial institutions to control risk as well as, or even better than, previously through daily reports and risk escalation alerts sent by the vendor.

8) SLAs are agreements between service providers and their customers regarding the level of service to be provided (definitions, scope, service specifications, targets, etc.). They specify the extent of the service provider's quality assurance to the customer.

(2) Long-term operational stability

Day-to-day operations are ultimately executed by humans. Financial institutions have repeatedly laid off back-office staff in response to shrinking trading volumes and their own downsizing. Such headcount reductions increase dependence on key personnel with mission-critical skills and pose a risk of failure to perpetuate operational know-how within the organization. With utility service vendors performing business processes for multiple financial institutions at once, they are able to adequately staff their operations and ensure stable IT system operations. Additionally, they update both IT systems and business processes in response to local regulatory or infrastructural changes and continuously amass specialized knowledge.

(3) Operating efficiency

Utility services also help keep operating costs under control. Unlike conventional business-process outsourcing vendors, many utility service vendors not only provide uniform processing but also can handle a wide range of back-office operations. They are consequently able to staff their operations and build system flows more efficiently than a single financial institution can. They can also greatly facilitate the introduction of new products or transactions by utilizing their IT systems, human resources and know-how.

As Japan's settlement infrastructure itself becomes more globally competitive, the banks and securities brokerages that participate in the settlement system also must increase their competitiveness. They need to develop more efficient and stable operating models so they do not end up shrinking or withdrawing from the Japanese market. With only limited time remaining to prepare for the T+1 JGB settlement cycle's test run in autumn 2017, now is the time for decisive action.

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Inquiries to : Financial IT Marketing Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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