Securities Finance & T+1

Securities Lending: Preparing for the Upcoming Settlement Cycle Change

This piece is focused on the securities lending community including lenders, lending agents, borrowers, beneficial owners, custodians, and other stakeholders.

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Accelerated Settlement

In May 2024, the U.S. (May 28) and Canada (May 27) will once again transition their settlement cycle. After more than 20 years without significant changes to the settlement cycle, there was a shift from T+3 to T+2 in 2017. Now there will be another shift, this time to T+1.

Why Accelerated Settlement Matters

The move to T+1 is intended to reduce costs, enhance market liquidity, increase market efficiency, and reduce settlement risk for investors and market participants alike. However, with an accelerated settlement window comes numerous material changes to the settlement process that pose technological, operational, and legal considerations.

Securities lending will be impacted, and modifications to processes and technology will be necessary to avoid a potential increase in settlement fails.

Firms will have to focus on accelerating several activities, such as:

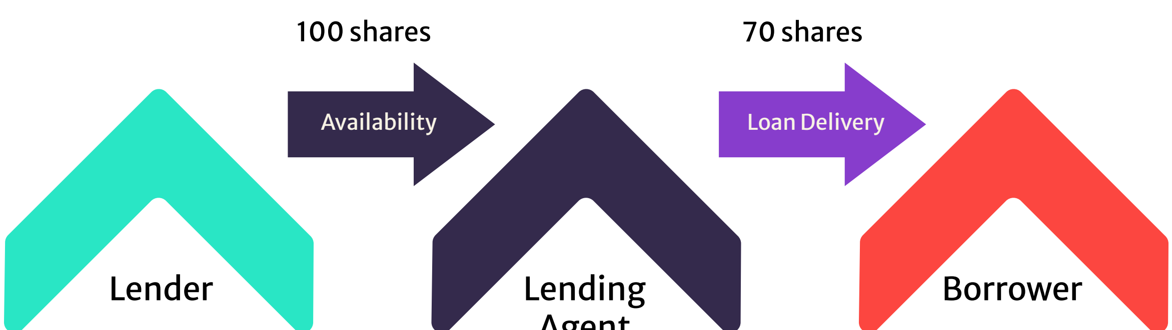
- Sell communication,
- Recalls, and
- Position sourcing

... while also reducing the time allowed to settle transactions.

To illustrate this, let's review a "Management of the Recall Lifecycle" example...

Management of the Recall Lifecycle

Prior to the lender's sale, its lending agent has loaned 70 shares to a borrower.



The lender has 100 shares in custody to be loaned out by the lending agent.

The lending agent negotiates and delivers a loan of 70 shares of the lender's position to the borrower.

The borrower receives the delivery of 70 shares of the lender's position from the lending agent.

Key Considerations on Trade Date (T/D)

On trade date, the lender sells out of the entire position of 100 shares. The lender issues a sell notification; the lending agent issues a recall notice to the borrower.

Lender: Position in custody: 30 shares → Sell Notification → **Lending Agent:** Position on loan: 70 shares → Recall Invoice → **Borrower:** Position borrowed: 70 shares

Current (T+2) cycle

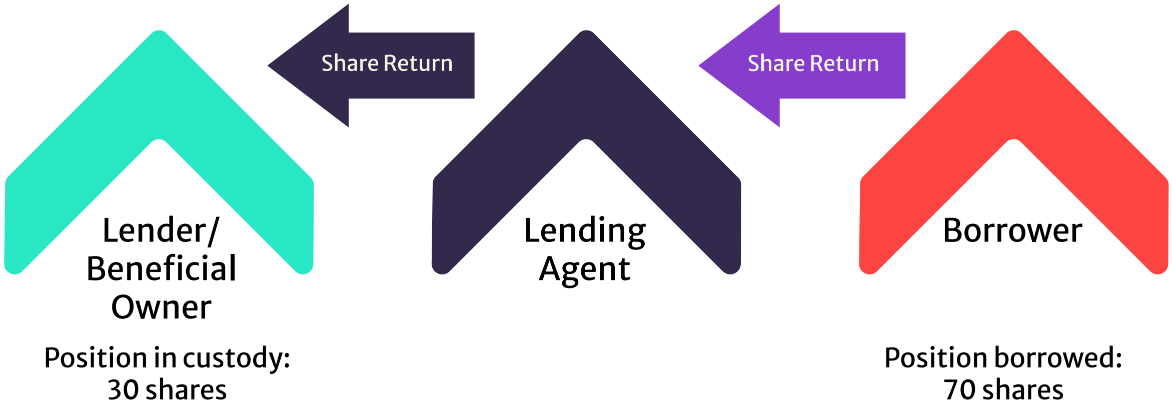
- Sell notifications are currently sent on trade date; however, many lenders use batch or manual processes, such as emails, to communicate their sells to the lending agent.
- Lending agents perform daily processes for position reconciliation, such as position to custodian recons and contract compare.
- Recall processing cutoffs are mostly defined in the Master Securities Loan Agreement (MSLA) / Service Level Agreement (SLA) between the lending agent and the borrower. Contractual cutoff time is typically close of business for DTC (4 pm EST).

T+1 Cycle

- Lenders need to prioritize improving the method of providing sell notifications to their lending agents, as several of them currently utilize batch/manual processing. *Consideration: Real time sell notifications, specifically SWIFT messages with the interested-party fields completed, may allow notices to be sent to the custodian and the lending agent simultaneously.*
- The timeliness with which lending agents complete their position reconciliation on trade date will determine their ability to swap or reallocate positions to accommodate sales. *Consideration: Lending agents automating the reconciliation of positions between counterparties wherever possible due to the shortened resolution window will expedite reallocations and swaps.*
- A “best practice” deadline of 11:59 pm ET for recall processing is being suggested to allow ample time for inventory management. *Consideration: Straight through processing (STP) of recalls should be standard practice for both borrowers and lending agents, with available industry utilities leveraged to their fullest capacity to avoid gaps in coverage.*

Key Considerations on Settlement Date (S/D)

On settlement date (S/D), the borrower is forced to source the position to satisfy the recall.



Current (T+2) cycle

- The practice of lenders settling partial positions in custody on settlement date is not widely adopted in the T+2 environment; they currently benefit from the additional day to receive the full position and avoid amending and reinstructing trades.
- Lenders usually spend the proceeds from sells on settlement date.
- Borrowers have until T+2 in the current environment to source their recalled positions.

T+1 Cycle

- Due to timing on recall processing and position sourcing, lenders would be encouraged to provide a standing instruction to their custodian to partially settle available positions for sales on settlement date as a best practice adaptation.
- The condensed recall timeline due to the T+1 environment requires tighter processing and turnaround times to limit potential impact of sell fail overdraft charge.
- As a result of the shortened settlement timeline, borrowers would need to begin their position sourcing process earlier in the recall cycle.

Post S/D Consideration (Rule 204[1])

- Given the consistent timeline for Rule 204 buy-ins (S/D+3), there are no increased risks for buy-ins anticipated.

Additional processes for consideration

Supplemental processes and functions need to be considered as part of overall impacts of T+1.

ETF Creation and Redemption
Issuers may need to confirm sufficient liquidity in the underlying securities

Corporate Actions
Shorter timeframe may be required to process entitlements and allocations for minimal disruptions to recall processing

ADR Issuance & Cancellation
Less time to ensure compliance with applicable regulations and tax requirements

Fees, Rebates, and Billing
Greater focus on timely reconciliation due to the shortened settlement cycle

1. Under Rule 204, equities must be delivered to a registered clearing agency for settlement on transaction settlement date or the fail to deliver must be closed out on T+6 for long sales. (U.S. Securities and Exchange Commission: Responses to Frequently Asked Questions Concerning Regulation SHO)

Key Takeaways...

Best Practice vs. Contractual Cutoff

- The best practice environment is meant to give borrowers enough time to efficiently complete their inventory management process and increase their ability to return shares faster and effectively.
- Contractual cutoff times for borrowers processing recalls will continue to be upheld based on their lending agreements (typically COB on T/D), as will any potential sell fail financing or interest penalties.
- Since there is no change to the timing of the execution of Rule 204, adhering to best practice timing for processing recalls does not increase risk to the beneficial owner of the position.

Master Securities Loan Agreement (MSLA) / Service Level Agreement (SLA) Review

- Both borrowers and lending agents should review language within their lending agreements that could be subjective or left open to interpretation regarding the settlement process.
- Securities Lending Agency Agreements (SLAA client agreements) may require review and modification as well around sale instruction deadlines.

Analysis of System Shutdown Timing

- Batch / manual processing of recalls in a best practice environment could lead to potential issues with industry utility system shutdown times.
- Adapting STP for recalls would alleviate the timing issue for recalls.

Contact us:

Michael Martinen

**Managing Director,
Financial Services, KPMG LLP**

T: 212-671-0152
E: mmartinen@kpmg.com

Thomas Gregory

**Risk Consultant,
The Risk Management Association**

T: 609-477-0856
E: tgregory@rmahq.org

Turgay Mehmet

**Managing Director,
Financial Services, KPMG LLP**

T: 646-249-9404
E: tmehmet@kpmg.com

Contributors:

Robimon Varughese
(Director, Financial Services, KPMG)

Jason Consoli
(Manager, Financial Services, KPMG)

kpmg.us

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