



CHALLENGES AND RECOMMENDATIONS FOR T+1

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1 EXECUTIVE SUMMARY

The volatility experienced in the market during the pandemic highlighted the crucial importance of Financial Market Infrastructures (FMIs) in maintaining stability within the global financial system. As part of their role, FMIs are currently exploring ways to enhance risk reduction by reducing settlement cycles and improving efficiency through the implementation of technology for all participants in the market.

This whitepaper focuses on outlining the current considerations and recommendations for shortening the settlement cycle to T+1 at an industry level. It was produced by B3 with input from representatives of brokerage firms, investment banks, custodians, and buy-side participants, ensuring a comprehensive and inclusive approach.

The implementation of the T+1 settlement cycle will require a reassessment of allocation, pre-matching, securities lending, and settlement processes, as well as a thorough evaluation to mitigate the impact on product liquidity. This may involve modifying existing workflows and eliminating any remaining batch processes to accommodate the shortened cycle.

This report is structured in 4 main sections: resume of benefits, challenges, recommendations and proposed timeframe to achieve T+1.

This document is intended to be distributed to industry participants to share with their internal business, operational, risk management, and technical teams. The purpose is to facilitate a thorough review of the implications of T+1 settlement on these specific functions. It is crucial for the market to actively engage in

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additional analysis and problem-solving to identify and address any potential root causes that could lead to settlement failures.

Firms should work with their counterparties, vendors, and clients to better understand their internal impacts related to timing requirements, system improvements, and process changes in preparation for this important step.

2 T+1 BENEFITS

The transition to a T+1 settlement cycle is expected to enhance the overall efficiency of securities markets. This shift will lead to improved utilization of capital, risk mitigation, and ultimately contribute to promoting financial stability. One of the key factors in achieving these benefits is the enhancement of operational and capital efficiency through increased automation in the post-trade process.

3 CHALLENGES ON T+1 SETTLEMENT

Besides the benefits of T+1 settlement, the industry believes that any plan for shortening the settlement cycle to T+1 should consider the following challenges:

- **STP is essential.** The market participants need to improve the post trade process through greater automation. The wide adoption of technology and software throughout the main flows is crucial to achieve optimal settlements in a T+1 framework.

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- **Increased risk of fails during the stabilization period.** Along with the summarized timeframe for sellers to source securities to return to securities lenders, lead to an increase in fails to deliver.
- **Securities lending.** Reducing the settlement cycle from T+2 to T+1 will result in a shorter timeframe for borrowers of securities and lenders to meet recall issuances and process them. The deadline for recall issuances will be adjusted to align with the T+1 cycle. This means that lenders will have less time to initiate recall instructions, and borrowers will have less time to return the securities for settlement. Any plan to shorten the settlement cycle should include measures to enhance securities lending processes, upgrade practices and systems, and minimize the risk of trade failures due to the compressed timeline.
- **FX challenges.** Participants typically determine their FX requirements only after they have executed a trade and received confirmation during the pre-matching process. For non-resident investors investing in BR assets trading at the BR market close, they will only know their investment needs for the following day. This may require them to hold cash to delay their investment, potentially resulting in performance drift during this period. Conducting the FX trade on T+0 is not feasible in this scenario, necessitating a shift to T+1 for FX transactions. It is recommended to engage in extensive discussions with the regulator to explore the possibility of extending the closing time for the FX session after the BR market close trading session.
- **Cash Funding (FX).** With the shortened time available to resolve FX or funding issues, there is an increased risk of delays in FX transactions,

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especially if the counterparts involved are located outside of BR. This poses a challenge as Carrying Brokers and Custodians may need to assume their clients' obligations in the event of a default. In the past, the differing market and cash settlement cycles were managed by utilizing extended settlement or fund overdrafts. However, these solutions are becoming more expensive to arrange due to the global increase in funding costs.

- **Concentration of processes during the beginning of T+1.** The allocation of trades for non-resident investors, pre-matching, custodian acceptance, securities lending and FX processes may be concentrated at the start of the T+1 settlement cycle. This necessitates the need for proactive planning and efficient processing, including the elimination of any remaining batch processes.
- **Liquidity of international assets in the Brazilian market.** Market makers of international assets, such as BDRs and International ETFs may close the day in a short position. Since they do not hold security inventory, it becomes necessary to order an issuance/creation of assets to meet the delivery obligation. Bringing the settlement cycle to D+1 increases the risk of settlement failures, with the application of fines that potentially discourage the market makers from operating in these assets.

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4. RECOMMENDATIONS TO ACHIEVE T+1 SETTLEMENT

This section provides an overview of the recommendations aimed at achieving a T+1 settlement cycle. B3 have conducted a thorough assessment of the operational challenges, identified best practices, and put forth recommendations.

It is important to note that the suggested timeframes presented below are subject to potential changes.

4.1 ALLOCATION

The allocation deadline for local investors has not been changed (by 7:30 pm for financial derivatives and commodities and by 8:30pm for cash equities and derivatives on equities). For non-resident investors, the recommendation is moving the allocation deadline for cash equities **from 3:30pm on T+1 to 9:00am on T+1** to accommodate instructions from investors in different time zones. Brokers are encouraged to continue the allocation of non-resident investors overnight. All the allocation submitted to the clearinghouse during overnight will be processed at the beginning of T+1 (from 06:30am).

Adoption of standardized messages to automate the communication between asset managers, brokers and custodians via iMercado is fully recommended (account registration and allocation flows).

4.2 PRE-MATCHING

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The **pre-matching process shall occur in parallel with allocation**. Otherwise, is likely to have a concentration of trades to be pre-matched at the beginning of T+1 (which is not desired). It's recommended the consumption of information provided by the clearinghouse in real time by the market. The clearinghouse provides information of trades allocated and net settlement instructions intraday. The adoption of pre-matching messages (iMercado) specially for non-resident investors is recommended.

4.3 CUSTODIAN ACCEPTANCE

The custodian acceptance of debit net settlement instructions shall be performed during **T+0 by 9:00pm** for local investors, in parallel with the allocation process. Whether is not feasible to conclude the process within T+0, it's recommended that custodians should continue the process overnight. All the custodian acceptance messages sent to the clearinghouse overnight will be processed at the beginning of T+1 (from 06:30am).

The custodian acceptance deadline for non-resident investors will be changed **from 9:30am on T+2 to 10:00am on T+1**. Adoption of messages by the custodians is fully recommended.

4.4 SECURITIES LENDING

In the current T+2 settlement cycle, there is a market practice for borrowers to source securities only on T+1 or on T+2, before the delivery settlement window. Along with the summarized timeframe, borrowers are encouraged to source

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securities **from T+0** or will lead to an additional risk of delivery failure. B3 and the market must consider improvements on securities lending process, adoption of best practices by the market, education and automation of processes.

It's recommended utilization of tools made available by vendors to streamline the recall, contract management, corporate action and rebates processes. For vendors and system providers who utilize overnight batch processing, the T+1 presents an opportunity to move away from batch processing and move towards real time. Automated workflow tools to reduce manual processes are fully recommended.

The existing timeline for recalls will be reconsidered to a T+1 settlement cycle.

4.5 DELIVERY SETTLEMENT CYCLE

The official delivery settlement cycle might be moved from **11:00 am on T+2 to 12:00 pm on T+1**.

The pre-delivery cycle process, which consists of settling the debit net settlement instructions with balance on CSD before the official settlement window, would occur 2 times a day, at **08:30 am and 11:00 am on T+1**.

In addition to the recommendations provided, it is crucial for the industry to actively engage in further analysis and problem-solving to address any potential settlement failures. This includes developing strategies to mitigate risks during periods of high market volatility and volume. The industry must be proactive in identifying and implementing solutions to ensure smooth and efficient settlements, even in challenging market conditions.

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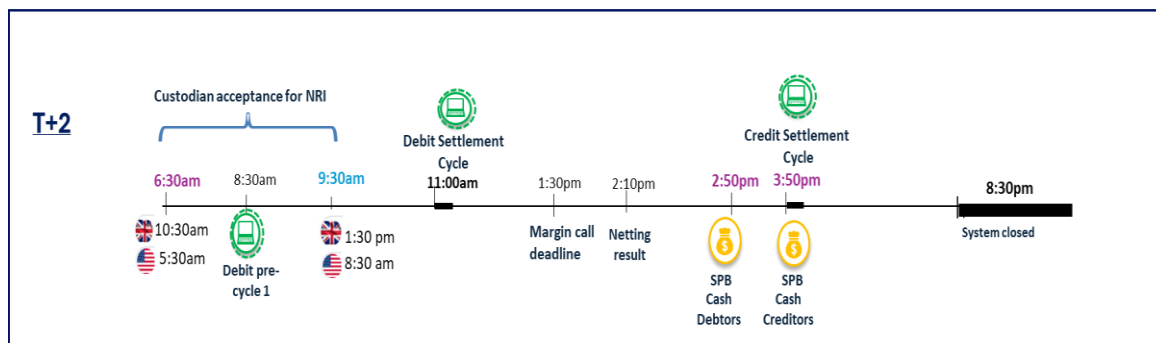
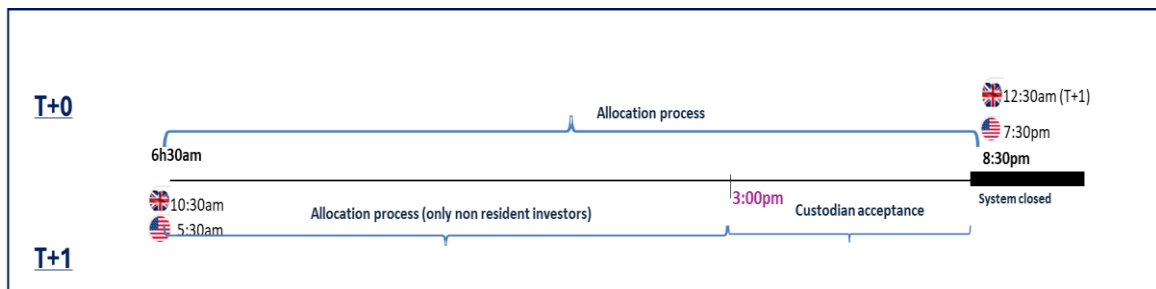
4.6 CORPORATE ACTIONS

Moving to T+1, the ex-date and record date would be the same date (T).

5 T+1 PROPOSED TIMEFRAMES

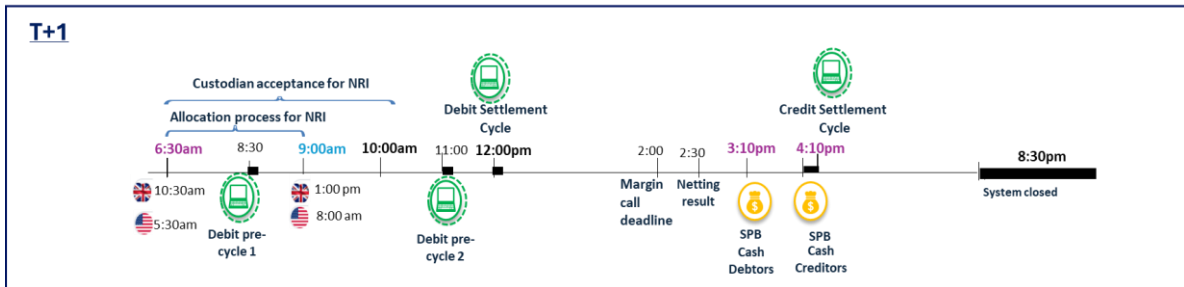
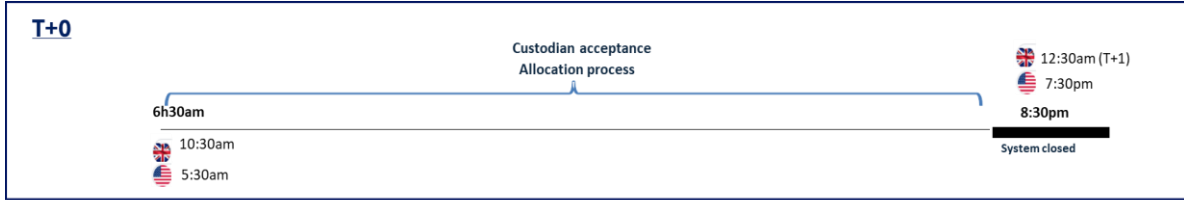
The proposed timeframe outlined in this document offers an overview of the key post-trade processes and their respective deadlines, including allocation, custodian processes, payments, and settlement. It is important to note that this proposal is subject to potential changes as further discussions and refinements occur.

5.1 THE CURRENT T+2 SETTLEMENT TIMELINE



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5.2 THE PROPOSED T+1 SETTLEMENT TIMELINE



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6 CONCLUSION

The reduction of the settlement cycle to T+1 has the potential to improve settlement efficiency by encouraging the industry to invest more in post-trading processes, in addition to the overall efficiency benefits of securities markets, better capital utilization, risk mitigation, and financial stability.

The B3 Clearinghouse enables the automation of processes by participants through the provision of post-trading message flows. Its adoption is highly recommended to help reduce delays, settlement failures, and associated penalties. The transition to a T+1 settlement cycle will require financial investments from the industry to address existing operational challenges, which will take time to implement. Internal processes will need to be enhanced to ensure that investor allocation, pre-matching, securities lending, and settlement are faster in all aspects. The adoption of technology will be crucial for all parties involved to ensure a reliable and successful migration to the new settlement cycle.

In addition to operational issues, there is concern about the reduction in the activity of market makers in international assets, such as BDRs and International ETFs, due to a potential increase in settlement failures and fines imposed given the shortened timeframe for issuances/subscriptions, which could result in decreased liquidity of these assets. The adoption of efficiency measures to mitigate the risk of settlement failure is necessary. Another point, such as the need for greater liquidity from participants to honor settlements with the Clearinghouse due to increased delays in currency exchange for non-resident investors, was also addressed as a challenge.

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A successful transition to the T+1 settlement cycle will require a collaborative and coordinated effort from all market participants, including B3, throughout the entire post-trading process. It is important for market participants to collaborate with their counterparts, suppliers, and clients to gain a better understanding of the internal impacts related to timing requirements, deadlines, system improvements, and process changes. This proactive approach will help prepare for the future state and ensure a smooth and secure implementation of T+1