The Future of LATAM's Securities Settlement

Efforts to further accelerate the flow of foreign investor capital into LATAM markets are underway, and it is being enabled through a number of initiatives – including stock exchange consolidation and post-trade reforms. Roberto Paolino, Head of Securities Services for Brazil at Citi, sat down with senior executives from the Stock Exchanges of Brazil, Chile and Mexico to discuss how the LATAM region is attempting to deepen its capital markets.

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Exchange consolidation takes shape

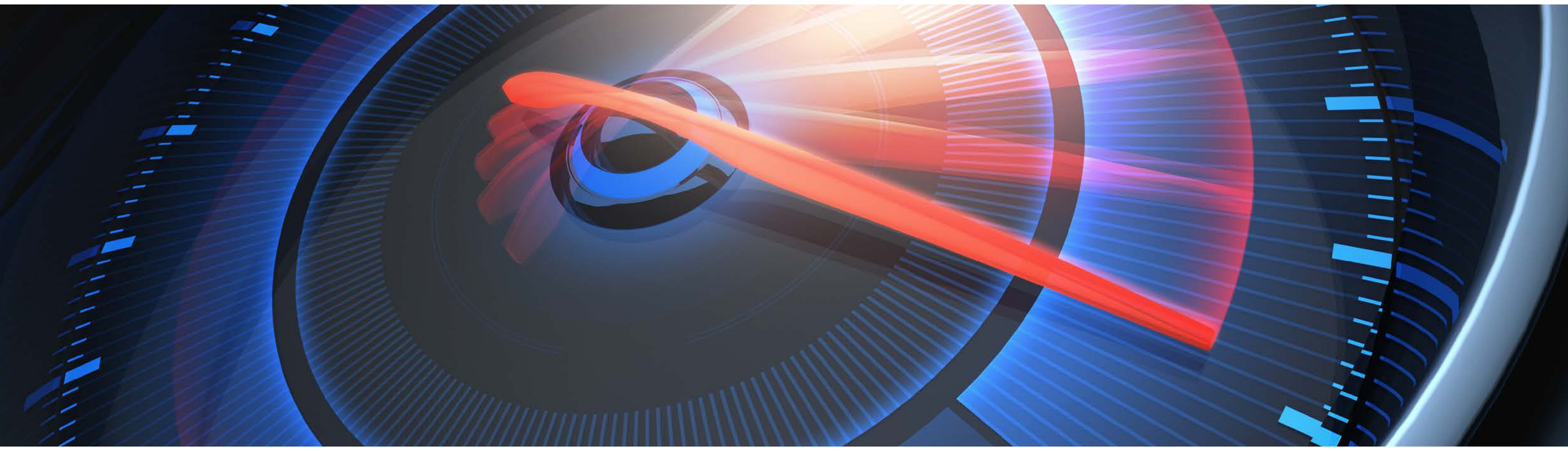
Just as the EU expedited cross-border investment and listing activities through harmonisation of its capital markets, LATAM is looking to follow suit. However, past attempts to facilitate standardisation and connectivity in LATAM's securities markets did not yield much success. Announced in 2011, the Latin American Integrated Market (MILA) was a well-meaning programme designed to homogenise the equity markets of Colombia, Chile, Mexico and Peru.

Although the plan was supported by all of the participatory countries' domestic Stock Exchanges and Central Securities Depositories (CSDs), arbitraging regulations and tax requirements – along with the absence of a shared currency – across the four markets meant trading volumes on MILA were limited.

Despite MILA's chequered track record, Andres Araya Falcone, Executive Vice President and Chief Business Officer at the Santiago Stock Exchange, says this has not deterred regional infrastructures from pursuing other ambitious integration programmes – as they look to stimulate liquidity in LATAM. "We all know that MILA did not have the success many expected, and it was tough and difficult to implement some of the back office processes. However, we have learned a lot from MILA," says Araya.

In 2020, the Stock Exchanges of Colombia, Chile and Peru confirmed they were in discussions about merging their respective businesses into a single holding company, in what would create the second largest bourse in LATAM. Under the scheme, Colombia Stock Exchange and Santiago Stock Exchange will each control 40% of the holding company, with Lima Stock Exchange owning the remaining 20%.

Admittedly, the consolidation plans were frustrated by COVID-19, but Araya stresses that progress is now being made. "We are ready to start with the integration and are in the process of selecting an international consultancy to work with us. In the next six months, we intend to create a holding company and will define how it will operate. This is a big challenge as we have to harmonise the regulatory rules across all three markets," adds Araya.



On timing, Araya shares that the holding company's electronic trading platform is poised to be developed in 2023 followed by the rollout of a clearing and settlement platform in Q3 of 2024 – coinciding with the US' introduction of T+1. If successful, this combined entity could help unlock liquidity in LATAM by attracting international investment; increasing the number of debt issuers; strengthening trading in derivatives and incentivising regional institutions, such as pension funds, to participate in the local market.[1]

"The merged entity will be a win-win scenario for shareholders, investors, issuers and intermediaries as consolidation will enable operational synergies to be realised, and this will be reflected in client fees," says Araya.

T+1 under discussion in LATAM

With the US (and Canada) expected to transition from a T+2 settlement cycle to T+1 in 2024, LATAM markets are keen to follow their lead. "When we moved from T+3 to T+2 several years ago, we also talked internally about the possibility of migrating to T+1,"comments Claudio Jacob, Managing Director, International Business Development, Client Relations at B3 in Brazil.

This is echoed by Roberto Gonzalez Barrera, Chief Executive Officer, Post Trade Division at Grupo Bolsa Mexicana de Valores, who notes the Exchange is having high level internal conversations about adopting T+1. "Mexico moved to T+2 at the same time as the US. This is because there is a strong correlation between our two markets. We have started engaging with the brokers' association and our board to move to T+1 at the same time as the US," says Gonzalez Barrera.

Araya also indicates that the Santiago Stock Exchange is looking to adopt T+1 as well. "There are a lot of arbitrages between Chile and international markets. Similar to Mexico, when the US market is closed, our trading volumes are reduced," says Araya.

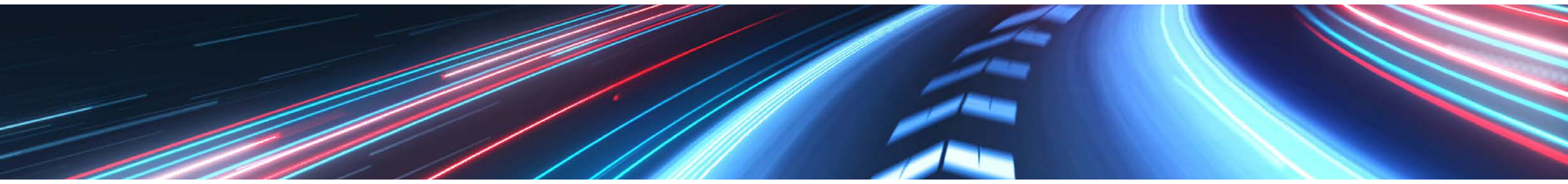
There are a number of benefits to removing an entire day from the trading settlement cycle. The introduction of T+1 could unlock many risk benefits for market participants, which in turn will expedite operational and cost synergies. As highlighted in "*Accelerating the US Securities Settlement Cycle to T+1*" – a shorter rolling settlement cycle will mean firms incur reduced systemic, operational and counterparty risk during the trade settlement process, something which could prove vitally important during bouts of volatility. These scaled back risk exposures will mean trading counterparties are subject to lower margin requirements, facilitating cash optimisation.[2]

"A shift to T+1 could bring about risk reduction benefits for investors, market participants and B3 itself as it would cut the settlement risk by half. Furthermore, T+1 would help Brazil synchronise with global markets, thereby reducing the cost of arbitrage. We also have a number of Brazilian Depository Receipts (BDRs) linked to Europe and North America, while a number of Brazilian companies are also dual listed in the US. Synchronising the time-frame for settlement would help eliminate unnecessary frictions," says Jacob.

T+1 adoption will also force intermediaries (i.e. custodians) to modernise any antiquated technology infrastructure and legacy systems, in what could potentially negate many of the pain-points synonymous with today's settlement activities – further crystallising some of the efficiency gains made already. "Compressing T+1 will require significant technology investment to be made by market participants," says Paolino.

Overall however, financial institutions believe settlement compression will yield major benefits. For example, 44% of market participants surveyed in Citi's Securities Services Evolution whitepaper said settlement compression would result in greater efficiencies in the investment and trading process.

[1] Reuters – November 30, 2021 – Colombia, Chile and Peru stock exchanges approve merger.
[2] SIFMA, ICI, DTCC, Deloitte – December 1, 2021 – Accelerating the US Securities Settlement Cycle to T+1.



Despite this, there are some significant barriers potentially impeding T+1's introduction in LATAM. "There are challenges to adopting T+1 in Brazil. The country has restrictions on pre-matching while STP [straight-through-processing] for allocations takes place on T+0," says Jacob. Additionally, there are concerns around FX management, as it could force investors in different time-zones to book FX transactions on either T or T+1 — something which might require them to pre-fund their trades.

"One of the major challenges for us is that between 50% to 60% of what is traded in Mexico are foreign securities. Our dual listing of securities program or "Global Market" has grown substantially, and we now have more than 3,000 foreign securities listed. T+1 could pose two issues: for local securities, where US participants are dominant, a trade instruction comes from a US fund to a US broker then to a local broker and after execution, the confirmation and settlement instructions must reach the local custodian same day in order to enable the delivery of the securities the next day (T+1). The other issue is what will happen for Mexican institutions buying, selling or arbitraging foreign securities? We have a lot to do in terms of speeding up the current trade confirmation and post-trade processes," says Gonzalez Barrera.

In addition, Gonzalez Barrera notes that Mexico's settlement fail rate under T+2 is currently less than 1%, but this could see a substantial spike if and when T+1 is adopted if they don't prepare properly for this change.

Is T+0 really on the cards?

With a number of markets actively talking about transitioning to T+1, some believe the introduction of T+0 is an inevitable next step, highlighting it will lead to further improvements in capital optimisation and risk management. Just as the Depository Trust & Clearing Corporation (DTCC) — through Project Ion — is trialling distributed ledger technology (DLT) to support T+1 and T+0 settlement — in parallel to its migration to T+1, Paolino questioned whether such a scheme would be feasible in LATAM.

"There are a number of benefits to T+2 and T+1. T+0 does happen in some markets but these are overwhelmingly OTC [over-the-counter] markets where there is no clearing or netting. There is nothing to prevent the establishment of a parallel T+0 market alongside T+2 or T+1, but those trading on T+0 would not get the benefits of T+2 or T+1," says Jacob.

Again, introducing T+0 is easier said than done. For example, the ISC report argues T+0's introduction would require a complete restructuring of the clearance and settlement model; revisions to regulatory frameworks and the implementation of real-time currency movements. The report continues that the costs of adopting new technologies would be disproportionately shouldered by smaller or medium sized firms who are reliant on legacy systems.[3]

"T+0 sounds great on the academic side, but if you look at the materials which the DTCC has published, then you realise it is a big challenge. A lot would need to change if T+0 was to be implemented, including maybe even getting rid of the CCPs [Central Counterparty Clearing Houses] that provide huge benefits such as assuming counterparty risk, netting, anonymous trading, among others. It is a much more ambitious project," says Gonzalez Barrera.

LATAM continues on its reform journey

As one of the regions hardest hit by COVID-19, LATAM is making huge strides to attract foreign investor capital. In addition to exchange consolidation, the region is open to the idea of settlement compression, replicating what the US is currently doing in terms of adopting T+1. Despite this, there are obstacles to be overcome. "Past regional integration projects have struggled to gain momentum, while the introduction of T+1 is likely to throw up logistical problems. Nonetheless, LATAM markets are continuing to move forwards and the adoption of a shorter settlement cycle is likely to help drive international inflows into the region's burgeoning and attractive economies," concludes Paolino.

[3] SIFMA, ICI, DTCC, Deloitte — December 1, 2021 — Accelerating the US Securities Settlement Cycle to T+1.

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