The move to T+1 – who really benefits?

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The Securities and Exchange Commission (SEC) has recommended moving the US Settlement process from T+2 to T+1 to reduce risk and strengthen and modernize securities settlement in the US financial markets. The question is, is the industry really ready for such an impactful change and the potential upheaval that such a change will bring, and what about the international impact?*

While Europe has so far remained silent, Asia has made some progress already. On September 7th, 2021, the Securities and Exchange Board of India (SEBI) granted its stock exchanges, NSE and BSE, the provisions to implement a T+1 settlement cycle in phases which started on February 25th, 2022. Hong Kong already operates its cash settlement on a T+1 basis.

Given major players in the US market have backed the move to T+1 for US and Canadian settlements, which will likely start in H1 2024, from a market and counterparty risk perspective, this is great news. While the move from T+3 to T+2 in 2017 was deemed a success, the move to T+1, removing half of the time allowed for settlement, will mean a more profound need to ensure everything is instructed correctly first time. The opportunities to make changes to resolve exceptions during the settlement cycle will be limited and will have to occur on trade date. Hence, firms need to urgently assess if they are truly ready for this market change, as the impacts are likely to be much more significant than just a reduction in time.

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As the Depository Trust and Clearing Corporation (DTCC) initiates the process of rolling out T+1, the market needs to appreciate that the last 2 years have put unforeseen challenges in front of all financial firms. The Covid-19 pandemic has rigorously tested firm's business continuity planning (BCP) efforts over the last 10 years and the trading in meme stocks, such as Gamestop & AMC, pushed up DTCC margin requirements significantly at brokers like Robinhood, which led DTCC to suspend trading in these volatile stocks. T+1 would lower the capital requirements at these brokers, but the increase in processing volume, would still need to be handled.

So, is the back-office ready?

T+1 will remove some market risks, but risk doesn't go away, it simply moves to another area and, right now, it looks like that area will be back-office operations.

Compressing the settlement cycle to T+1 will demand that operational risk is mitigated. Any manual processes will immediately come under pressure, as automation should be a prerequisite for a T+1 environment to ensure exception management is limited and there is as little risk of trade failures as possible. Technologies such as the humble fax machine and emailed spreadsheets need to be retired for more automated tools, with operational controls built-in, so staff can focus on exceptions and correcting transactions. Furthermore, firms should be looking at the root causes of exceptions to amend any obsolete or outdated processes to ensure those exceptions are avoided going forward.

But these are obstacles the back-office can mitigate and overcome by putting controls in place. However, other areas outside of pure technological changes need to be considered:

- Foreign exchange (FX) transactions traditionally settle on a T+2 basis. For international participants wanting to buy US securities, prefunding the transaction with USD or arranging for a short-dated T+1 FX settlement will be required. The effect of prefunding could potentially impact other investments, resulting in an investment manager being out of the market for 1 day. This is of particular concern to investors in Asia-Pacific markets, given the time zones.
- Corporate actions customarily have ex-date one day prior to the record date, enabling more trades to settle in advance of the record date cut off. The US market change will mean that the ex & record dates will need to be the same day which will undoubtedly lead to more reconciliation issues and subsequent market claims.
- Any cross-border transactions will be operating across two different settlement cycles resulting in further operational risk and staff pressure.
- A time constraint on securities lending where the lender will either need to get the original securities back from loan or substitute the lender with another party will bring challenges where the security has been sold late in the day on T+0 in order to effect settlement the following day.

These additional risks and issues will potentially offset some, or maybe even all, of the gains made from the decrease in market and counterparty risk. Whether it is more risk overall, is something operations managers need to monitor as they prepare for tomorrow.

So, what's the answer?

US banks, brokers, and investors need to initiate an assessment of their current post-trade technologies and processes, from front-office to back to ensure that they are ready both from a technology and an operational standpoint for T+1. Foundational account and standing settlement instruction information needs to be 100% accurate and available to counterparties, as there is no margin for error in a T+1 settlement environment. If firms do not have the optimal post-trade processes, they could be in for a difficult and expensive journey once T+1 goes live.

The decision for clients to replace legacy technologies and processes with a holistic open platform and integrated post-trade framework must now be considered to future-proof the organization. Real-time processing will need to be the standard and it will need to operate 24/7 to ensure the best outcomes.

Whatever the current state of your post-trade infrastructure, there is no time to delay, an urgent review is needed now to ensure you are ready for T+1 in 2 years' time.

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* https://www.sec.gov/rules/proposed/2022/34-94196.pdf