SECURITIES TRADING: SHORTENING THE SETTLEMENT CYCLE FROM T+2 TO T+1

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The standard settlement cycle for most securities transactions is T+2, which means that settlement occurs two business days after the trade date. The "T" stands for the transaction date. However, the Securities and Exchange Commission (SEC) of the US has passed a new rule to shorten the settlement cycle to T+1. The rule is scheduled to take effect in May 2024. In this note, we have analyzed the pros and cons of a shorter settlement cycle for investors.

The background

The trade settlement process involves the transfer of securities from the seller to the buyer and the transfer of funds from the buyer to the seller. The settlement period has changed over the years as securities trading has moved from manual to electronic transactions.

The SEC initially set the settlement period to five business days. However, it was revised in 1993, when the SEC changed the settlement period from five business days to three business days. In March 2017, the SEC again revised the settlement period from three business days to two business days.

Going forward, from May 2024 onwards, the settlement period in the US will be further shortened to one business day or T+1. The T+1 settlement means that when you buy or sell a security, the actual transfer of the security and the payment occur on the next business day after the trade. Global trends are towards the shortening of settlement cycle (please refer to the table below).

The T+1 settlement cycle timeline

Region/ Country	T+2 Settlement Cycle	T+1 Settlement Cycle
Northern America	Settlement cycle shortened from T+3 to T+2 in 2017	T+1 discussion kicked off last year to shorten the standard securities settlement cycle from T+2 to T+1 by 2024 in US/Canada. US/ Canada plans go-live in May 2024
Mexico		Mexico has recently announced plans to join US/Canada in the T+1 move, still subject to obtaining local securities regulator and central bank approvals.
India		T+1 ran in conjunction with T+2 until January 2023.
Europe	In October 2014, 29 European markets moved from T+3 to T+2.	EU regulators indicate that T+1 is being considered as part of ongoing CSDR refit; timing unknown at this time.
UK	T+2	UK HM Treasury has also expressed interest in T+1 planning and have formed a consulting team to assess.
Saudi Arabia	Tadawul, the Saudi Arabian stock exchange, has officially moved to a T+2 settlement cycle for listed securities, from its earlier pre-funding requirement till 2017	
Qatar	The Qatar Stock Exchange (QSE) will shift to a shortened settlement period T+2 from the present T+3, effective from January, 2024	
UAE / Bahrain	The trades settle on T+2 basis	
Oman	Muscat exchange settles on T+3 basis	
Egypt	The standard settlement in Egypt is T+2	
Other markets		Several markets have introduced T+1 for limited sets of securities over time, most often for fixed income.

The impact of the T+1 settlement cycle on market participants

The impact of the T+1 settlement on market participants, such as investors, brokers, and custodians, will be multifold. The timeline for trade allocations, affirmations, matching, trade instructions, mismatch resolutions, and FX cut-offs will become tighter.

One of the key changes that the T+1 would trigger is multiple funding and settlement considerations across all global markets. Pre-funding trade settlement could be considered by international managers due to FX settlement cycle and different trading time zones. Securities lending, standard processing and security recalls will have to operate in a much more compressed timeframe.

The back office and middle office processes will have to rely more on automation to match the trades and confirm them sooner. Automated processes and systems will need to be implemented by market participants globally to achieve straight-through processing and meet the accelerated settlement timeframe.

The ex-date for an investor to receive dividend will shift from one day prior to the record date (in T+2 settlement cycle), to the same day as the record date (in T+1 settlement cycle).

Advantages of the T+1 settlement cycle

Reduced counterparty risk. The counterparty risk is a risk that arises when one of the parties to a trade fails to meet its obligations. The T+1 settlement can reduce counterparty risk by shortening the time between the trade and the settlement date.

Increased market efficiency. The T+1 settlement can make markets more efficient by reducing the amount of time that it takes for securities to change hands. This can lead to lower transaction costs and tighter spreads due to increased liquidity.

Improved risk management. The T+1 settlement can help investors to better manage their risk by giving them more control over their investments. For example, investors who are concerned about market volatility can sell their securities and receive payment on the next business day.

Disadvantages of the T+1 settlement cycle

Increased operational costs. The T+1 settlement could lead to an increase in operational costs for market participants, as they will have to process trades more rapidly.

Potential for disruptions. The transition to T+1 settlement could cause increased disruption in the markets, particularly if there are any technical glitches as it will give less response time.

Impact on the international markets. The T+1 settlement could have an impact on international markets, as some countries have different settlement cycles.

The T+0 settlement cycle - the next step

The industry does not support any further reduction to T+0 settlement for markets with high volumes at present. Given the magnitude and complexity of the changes required to the existing post-trade infrastructure. However, the Indian regulator SEBI recently announced that they are aiming to reduce the settlement cycle to same day settlement (T+0) by March 2024. By 2025, there will be an optional parallel system for instantaneous settlement. India is rapidly shortening the settlement cycle compared to its global peers due to the technological advancement and the pace at which technology is being deployed.

Conclusion

Overall, we believe that the potential benefits of T+1 settlement outweigh the potential challenges. We think the move towards shorter settlement cycles, such as T+1, is a way to reduce counterparty risk and enhance market efficiency. T+1 settlement will make market more efficient and reduce the risks for investors. The move to T+1 settlement in the U.S. could lead other major financial markets to reevaluate and possibly shorten their settlement cycles to remain competitive and align with international standards.