T+1 Accelerated Settlement | FX Considerations

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The Global Impact of an Accelerated Settlement Cycle

The Securities Exchange Commission ("SEC") confirmed that the United States securities settlement cycle will move from T+2 to T+1 in May 2024, in coordination with Canada and Mexico. Innovative solutions are required to address these new challenges, anticipated to have a profound impact across today's capital markets operations and technology. With the knowledge acquired from firms' readiness initiatives, internal and industry-wide due diligence activities, the foreign exchange market ("FX") has been identified as an area of attention for foreign participants seeking to invest in U.S. securities.

While challenges will vary by company, the adoption of T+1 increases the possibility that transaction funding dependent on FX settlement may not occur in time increasing risk for the buyside, custodians, and brokers. Firms should consider the potential increase in operational risk across all aspects of the trade lifecycle, including in the FX trading process itself, pre- and post-trade operations, payments, and settlement.

The Foreign Exchange Professionals Association (FXPA) convened a T+1 Settlement Working Group with Global Financial Markets Association's Global Foreign Exchange Division (GFXD) to discuss the potential FX implications. The Working Group developed guidance related to trading to provide a framework of voluntary, non-binding recommendations that assist in preparation for the move to T+1 settlement in May. A copy of their findings can be found here.

This whitepaper uses the FXPA framework to provide additional guidance and considerations for FX market participants, based on continued insights gained as the industry moves toward T+1 adoption.

Solving for Participants FX Concerns

FX risk can be mitigated through a combination of liquidity and cash management strategies. Firms can manage U.S. dollar (USD) liquidity by using derivatives, pre-funding cash balances, forecasting cash flows, executing trades based on estimated FX requirements and "truing up" actual FX needs after the fact, and trading FX directly with custodians or other FX bank relationships. Continuous Linked Settlement (CLS) [1] is a payment vs payment (PvP) mechanism used to help mitigate settlement risk. Other CLS netting services include CLSNET[2] that help to automate bilateral netting calculations and offer greater operational efficiencies for 120 currencies including non-CLS eligible emerging market currencies. It is worth noting that while CLS is one PvP mechanism, others are also being developed to help mitigate FX Settlement Risk.[3] The below delves into different approaches firms can take to mitigating these concerns.

1. Review Deadlines

Market participants completing FX via CLS may not have sufficient time to ensure their FX settlement instructions are submitted by the 6:00PM EST CLS cut-off time on trade date (T+0). Specifically, firms that trade at Market on Close (MOC) will need to consider the 2-hour window to complete post-trade steps necessary to deliver FX settlement instructions to their banks and/or custodians.

To help address these issues and provide more time for global participants, CLS is evaluating any changes that would help support the new T+1 environment and reduce funding and settlement risk. CLS recently surveyed participants around changing the settlement cut-off to as late as 7:00PM EST. This

[1] Today, CLS estimates it reduces daily FX funding requirements by 96% and nearly eliminates settlement risk on more than 1 million FX transactions worth over $6.5 trillion across 18 currencies. CLS has 74 member banks/custodians worldwide and is regulated in the US by the Federal Reserve Bank (FRB) of New York. See https://www.cls-group.com

[2] CLSNet is a bilateral payment netting calculation service, for foreign exchange trades. As a centralized platform, the service delivers operational risk mitigation by standardizing and automating the net calculation process. See https://www.cls-group.com/products/processing/clsnet/

[3] BIS - CPMI Jul22 "Facilitating increased adoption of payment versus payment (PvP)" https://www.bis.org/cpmi/publ/d207.htm

study is still ongoing, and a recommendation is anticipated to be made in Q1 2024. However, even if the rule changes are approved, the implementation process required for the extension would likely not come into effect until early 2025.

Furthermore, while the CLS deadline is 6:00PM EST, banks and custodians likely have earlier deadlines to complete internal processing and remit to CLS. Firms should reach out to their relevant counterparties and custodians to confirm future-state deadlines and adjust operational processes accordingly.

2. Assess FX Funding Requirements

Among the key considerations around FX and T+1 is the level of FX spot market liquidity, particularly between 4:00PM and 5:00PM ET. Firms could likely face higher volatility and wider spreads with the additional demand for liquidity at the end of the day.

T+1 U.S. Securities settlement may see shifts in FX liquidity to help accommodate the expected increase in trading volumes in the NY trading session. This may include extended trading hours and changes to current trading patterns by the broader FX market participants.

Prior to the transition, firms should assess credit lines, banking, overdraft facilities, and what funding is already committed. This will help foreign participants firms to be better prepared during periods of higher market volatility or reduced FX liquidity where there could be a funding crunch.

In addition, firms should consider how to respond if FX transactions fall outside of the CLS window. FX transactions can settle T+1 and T+0 - outside of CLS, providing they meet funding and local currency cut-off times. If timing constraints prevent CLS processing, buy-side participants, custodians, and sell-side participants need to ensure their FX counterparties can accommodate T+1 or T+0 (same-day) settled FX trades.

3. Align FX Operations with Time Zone Demands

Global firms that do not have an office in the U.S. Eastern time zone (“ET”) may wish to evaluate whether adding an FX trading desk and building additional presence in an ET location is feasible and a helpful strategy to reduce FX-related risks. This would allow for a local presence to manage FX activity in the U.S. trading day and help mitigate some of the operational challenges, while maximizing the window to settle trades inside of CLS before the 6pm ET deadline. Another approach firms could adopt to mitigate time zone differences is to establish trading desk and trade support functions across regions. By adopting a follow the sun model, firms will improve their capabilities to manage 24-hours FX processing.

For firms that consider establishing U.S.-domiciled locations or “hub and spoke” models as too costly, another option to consider would be leveraging an automated or outsourced solution. This approach allows for automated execution sweeps during the correct timeframes without requiring an increase in headcount. Streamlining trade management and the FX execution workflow through outsourcing could mitigate FX timing constraints imposed by T+1 settlement with little impact to headcount.

4. Streamline Operational Processes

While there are “bigger picture” solutions to solve time zone and liquidity problems, there are also marginal operational efficiencies firms can employ that collectively, may provide meaningful benefit.

For example, prior to trading, firms should confirm all new accounts that are opened with counterparties and verify that they are properly configured for FX trading. By ensuring that accounts are onboarded with the accurate Standing Settlement Instructions (SSIs) and agreements in place, delays in meeting currency cut-offs and settlement times will be reduced. In addition, firms could also consider linking industry best practices for other asset classes to FX workflows, like establishing connection between CTM's Match to instruct (M2i) and an automated FX workflow tool to automatically execute FX trade after affirmation of security trades.

Another option for firms to consider is adopting an automated client onboarding solution. This may alleviate the process and mitigate settlement risk with counterparties and decrease the likelihood of trade breaks and limit reconciliation activities that hinder timely settlement. This will also serve as a long-term solution for firms that are looking to improve operational efficiency.

Concluding Thoughts

The FX market is the world's largest and most liquid financial market. FX market participants engage in currency exchange transactions across many different jurisdictions and time zones. Therefore, organizations will need to work cohesively with participants across the financial markets to help reduce the risk of any adverse impacts associated with the accelerating U.S. securities settlement cycle for international investors and FX markets.

The T+1 securities settlement cycle will provide an opportunity to create some of the industries best practices related to accelerated settlement. Market participants can use this change to optimize their existing and newly constructed business models that support their day-to-day trading operations.