Shorter Settlement Cycle *Reshapes FX Management*

The introduction of T+1 in North America (i.e. the US, Canada, Mexico) is expected to transform how global FX markets operate. In particular, Asia Pacific and Europe-based firms need to ensure that their FX processes are well-positioned to deal with the impact of the upcoming shorter settlement cycle.

Less time to process FX

T+1's introduction in North America is going to have a significant impact on the FX management practices at all investors, but the ripple effect will be felt most acutely by those in Asia Pacific and Europe.

Cutting the securities settlement cycle in half from two days to one day does not mean organizations have 50% less time to carry out their post-trade responsibilities. In fact, the challenge is far more daunting. According to the Association for Financial Markets in Europe (AFME), the amount of post-trade operations time in a T+1 cycle will reduce by 83% from 12 hours to just two hours.[1]

In Asia Pacific and European markets where the time-zone differences with North America are particularly stark, financial institutions may need to book their FX transactions on a same day basis, as opposed to T+1.

It is inevitable some firms will struggle to complete their FX funding on time, resulting in more settlement fails, leading to higher operating costs and overdraft charges.

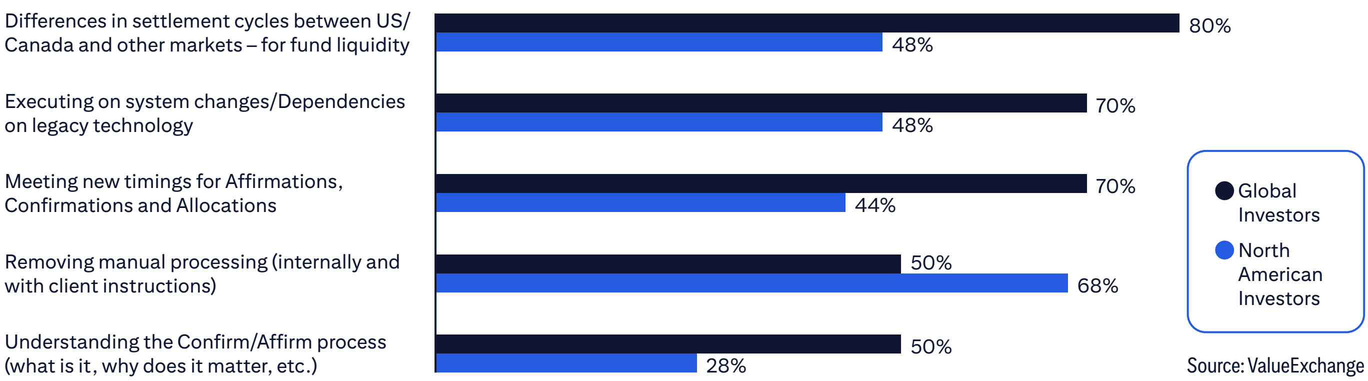
Although there are currently no cash penalties in the US for trade fails, it is a possibility the Securities and Exchange Commission (SEC) could one day introduce them.

However, 80% of global investors indicated in a recent ValueExchange survey that funding issues would be their biggest T+1 challenge, putting it ahead of implementing system changes and meeting the new timing requirements for affirmations, confirmations, and allocations (see Figure 1).

Figure 1

Funding issues are a T+1 readiness challenge for 80% of global investors

% of North American and Overseas investors facing issues (blocking and inconvenient) ahead of T+1



Source: ValueExchange

As mismatches in global settlement cycles become increasingly common, it will force buy-side firms to fund the one day difference when selling a security in a T+2 market to finance the purchase of a security in a T+1 market.

This is because the sale of a T+2 security will not settle on time to process the necessary FX conversion for funding the purchase of the T+1 security, which is settling one day prior.

There are solutions available, however.

Firms could, for example, fund the one day difference either through their own cash reserves or by negotiating a credit facility/overnight bridge facility with a custodian allowing the T+1 security purchase to settle.

However, these funding mechanisms will incur additional costs.

FX settlement risk will intensify

The move to T+1 will exacerbate FX settlement risk by making it more difficult for FX transactions to settle on Continuous Linked Settlement Group (CLS), a problem that – again – will hit institutions in Asia and Europe the hardest.

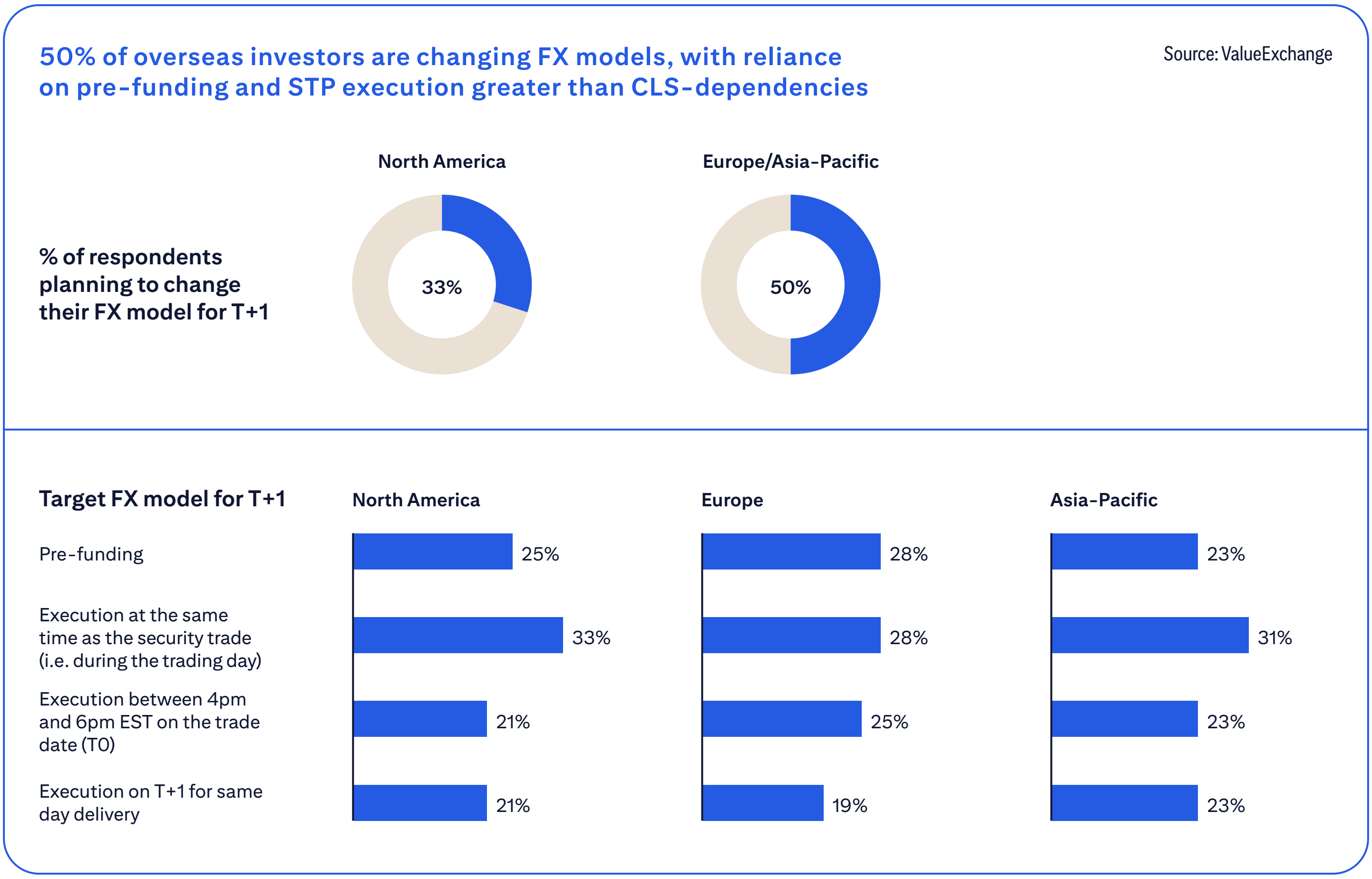
Introduced over 20 years ago to reduce settlement risk in FX markets, CLS ensures FX trades settle on a payment versus payment (PvP) basis. Once T+1 takes effect, market participants will be expected to submit FX trades to CLS by 6PM EST, although custodians often have their own deadlines which can be one or two hours (4PM EST- 5PM EST) before the CLS cut-off time. As the US equity market closes at 4PM EST, firms will only have a narrow window – if any at all – to send their FX trades to CLS.[2]

Firms located in Asia Pacific and Europe will likely struggle to get their FX transactions over to CLS by the 6PM EST cut-off time leaving them with little option other than to settle their FX trades bilaterally outside of CLS' scope, increasing the risk of trade failures.

While CLS has spoken tentatively about extending its cut-off deadlines by anywhere between 30 minutes and 90 minutes, this will not be a straightforward process, nor is it going to happen in time for T+1's implementation. Although such a move could benefit US investors, who book their equity and FX transactions near to the US market close, it will be of less intrinsic value to firms in Asia and Europe.

This has prompted investors in Asia Pacific and Europe to reduce their CLS dependencies in favour of pre-funding and Straight-Through-Processing (STP) execution. (see Figure 2 below)

Figure 2



Public holidays pose a logistical challenge

Investors in Asia Pacific and Europe could encounter challenges when booking FX trades under T+1, if a non-US public holiday happens to fall on T+1.

For instance, a Hong Kong-based manager with a HKD denominated fund wanting to buy US equities will be unable to book the FX trade on T if T+1 is a holiday in Hong Kong, as the trade cannot settle on T+1, nor will there be any liquidity available for T+1. Traditionally, settlement dates need to fall on business days for each of the currencies in a currency pair. If one currency has a public holiday on settlement date, the delivery moves a business day later.

There are ways for managers to overcome this obstacle.

They could pre-fund the transaction by booking the FX trade before the security trade. Another approach would be to book the FX trade as a T+0 trade prior to the relevant cut-offs on the day of the security trade.

If all options have been exhausted, the manager could ask a broker to book a T+1 equity trade on T+2, allowing for the FX leg of the transaction to also settle on T+2. However, non-standardized settlement cycles like this require a lot of manual intervention and often introduce an additional layer of operational risk, so this should only be done very sparingly – if at all.

Transaction costs need to be considered

For currency traders, FX prices are at their most optimal when markets are both liquid and active, which is normally around 1PM CET – the point at which markets in Asia Pacific, Europe and the US are all open.[3] Conversely, FX prices are typically at their worst at the US market close, when markets are quiet and illiquid – yet this is the exact same time that T+1 will require a large number of investors to make their FX submissions.[4]

While the introduction of T+1 might lead to wider FX market spreads and higher transaction costs in the short-term, client trading behaviour and the FX market structure are likely to change over the medium to long-term, potentially resulting in better liquidity – and therefore pricing – at the US market close.

Getting over the finish line

Despite T+1's rapidly encroaching deadline, a report released by the ValueExchange in October 2023 found that while 75% of global financial market participants have begun their preparations for the move to T+1, this drops to 57% among European investors, and just 25% in Asia Pacific.[5]

Some experts believe the lack of preparation in Asia Pacific is partly because the region's two biggest equity markets already have shorter settlement cycles (i.e. T+1 in India; T+0 in China) and local investors have adapted seamlessly. The big difference, however, is that the US is the largest equity market in the world by some distance, so the impact of T+1 will be much greater.

While Asia Pacific and Europe based firms are behind the curve on T+1, they still have time to execute their plans.

There can be no compromise on testing

Firstly, financial institutions must test their systems and processes – including FX – ahead of the go-live date in May.

Since August 2023, the Depositary Trust & Clearing Corporation (DTCC) has been running a dedicated T+1 testing facility on fortnightly cycles, allowing for market participants to check whether their systems are fit for purpose.

The DTCC's testing facilities will be open right up until the T+1 implementation date, and firms should leverage it while the resource is still available to them.

Getting the resourcing right

Asia Pacific and European firms will also need to make some major structural changes to their operating models if they are to support FX in a T+1 environment.

Some firms, for example, are looking to transfer FX dealers/traders and post-trade processing teams to the US, while others are introducing night shifts. Although both options are sensible, they will cause fixed costs to rise at a time when many buy-side firms have seen their revenues contract due to high inflation, challenging performance conditions, and new regulations.

Build in-house or outsource?

With many firms still highly dependent on manual based systems, automation will be essential in helping organizations manage their FX and achieve true STP.

Nonetheless, digitalization on this scale will ultimately eat into margins if the project is internalized.

A simpler solution might be to outsource FX executions to a custodian who has the operational capabilities to support efficient FX execution and settlement. Many custodians can offer later cut-off times for FX trades done in-house due to cash movements being internal, giving clients more time to process securities settlements and mitigate the risk of failed settlement.

Moreover, custodians' ability to offer a 'follow the sun' operating model will be a critical enabler for buy-side firms located in different time zones to North America.

Best Practices

- **Determine** impact on current operating model and assess potential changes required.
- **Explore** potential need for utilization of different geographies for operational processes.
- **Improve** post-trade efficiency by investing in technology and rethinking internal processes, including post-trade checks.
- **Review** pre-funding options for US equity trades.
- **Partner** with your Custodian(s) on potential FX solutions.

The domino effect has just begun

With just three months to spare, Asia Pacific and European buy-side firms need to start enacting their T+1 strategies and updating their FX management processes.

It is also increasingly evident that more markets will soon announce that they too will move to T+1 in the coming 18-24 months. It is probable that the UK and EU – together with several LATAM economies (i.e., Chile, Colombia, Peru) – will introduce T+1 from as early as 2025.

For many buy-side firms, the North American transition to T+1 is only just the beginning.

[1] AFME – September 21, 2022 – T+1 settlement in Europe: Potential benefits and challenges

[2] ISSA – T+1 Global Impacts

[3] The Banker – August 23, 2023 – Settling FX in a T+1 world

[4] The Banker – August 23, 2023 – Settling FX in a T+1 world

[5] Global Custodian – October 16, 2023 – New T+1 study reaffirms pain points outside of US around securities lending, FX and funding

To find out more about how we can help you navigate this upcoming move to T+1, contact your Citi Representative or email SecuritiesServices@citi.com.

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