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ACI FMA Briefing Note

USD T+1 Securities Settlement
and the Impact on FX

Introduction

The US Securities Settlement system will move to T+1 from 28th May 2024.

This Briefing Note aims to provide an overview of the key issues that have been raised by members of the ACI FMA FX Committee and their wider contacts, regarding the implications of this change for FX Market Participants. Failure to prepare for this change may result in firms suffering significant unexpected costs.

According to notices from DTCC and SEC, "US Securities Settlement" includes US cash equities corporate bonds, unit investment trusts ("UITs"), mutual funds, exchange-traded funds ("ETFs"), American depository receipts ("ADRs"), security-based swaps, and options. This change will not only occur in the US but also in Canada and Mexico. For simplicity, this document will refer to all the above as "US Securities".

It is important to note that, as of yet, there is no intention for FX Spot settlement to move across the markets from T+2 to T+1, in line with the change in the settlement of US Securities. However, it is widely accepted that the impact of US Securities settlements will impact the functioning of the FX Market. Some commentators have suggested that this change may potentially cause other currencies to similarly move to T+1, given that at least 85% of trading in the Spot, Forward and Swap markets features the USD in one leg of the transactions. There is no indication from ACI FMA members that such a change is imminent. However, figures published by the GFMA state that almost 20% of US Securities and 16% of US equities are held by Offshore entities, giving rise to significant FX exposures and, consequently, hedging requirements. Therefore, it is reasonable to assume that the change to T+1 for US Securities will have a significant impact. Our members should prepare and consider the issues covered below, as well as others that may not be discussed in this note.

In summary and taking into account comments from discussions with our members, the main areas highlighted do not relate to the mechanics of FX Trading itself (although liquidity will be impacted) other than in relation to funding. The areas of concern relate to the risks posed in liquidity and therefore transaction cost, funding, settlement, and operational processes. The FX Market already has well defined processes for settling on a T+1 basis. However, the move of a significant percentage of the current Spot FX flow to T+1 coupled with the likelihood of execution late in the US day and the resulting increased volumes at T+1, may have consequences. This may require a careful review of existing processes within firms.

Liquidity, Funding and Transaction Costs

The Trade lifecycle for FX T+1 settlement (Outright TOM) is well established and part of normal business. However, the change in US Securities Settlement is likely to have several impacts. The timing of FX transactions to cover Security settlements will present differing degrees of concern depending on the time zone of Market Participants involved. It is common practice to execute FX transactions related to US Securities on or near the close of the securities markets, implying a significantly larger volume of transactions for T+1 settlement - as late as 4pm EST. The extent of these implications will vary depending on the geographic location of Market Participants in FX transactions. For Market Participants in time zones significantly ahead of the US, settlement will effectively be at T+0. This, along with other factors mentioned below, may have the effect of excluding some Market Participants from executing this additional T+1 flow. This flow was previously manageable as FX Spot but with some participants effectively excluded, it is likely that there will be a decrease in the overall liquidity pool for these transactions.

Volumes traded in T+1 tenors will increase and whilst T+1 FX is generally a very liquid market in major currency pairs, it may be subject to spikes at certain times of the day (e.g., 4pm EST) that were previously less liquid. This may also give rise to liquidity issues in other less liquid pairs, all of which could lead to increased transaction costs.

Processes to establish and manage funding requirements for FX transactions on T+1 are again well understood and normal business practice for firms. However, the move to T+1 will place more pressure on this mechanism, and increased pressure may lead to errors that result in material charges on unfunded currency accounts. As a result, careful consideration should be given to the co-ordination of trade execution and funding.

Confirmation & Settlement

In a T+1 settlement scenario, the time available to match and confirm transactions is shorter, and many firms will already have experience with this, both for CLS and non CLS currencies. Whilst the cut-off time for T+1 trades inside CLS is 6pm EST, assuming no other restrictions imposed by third-party CLS agents, those settled outside of CLS will require more consideration. Trades that do not meet the CLS deadlines, but which can still be settled bilaterally, taking into account cut-off times and other restrictions, will face increased settlement risk that needs to be taken into account. With the increased margin for error due to contracted settlement times, automation and PvP systems will likely become even more important.

Indeed, with more volume shifting to a T+1 basis, the challenges of confirming transactions before settlement will increase. As a result, firms may choose to review confirmation mechanisms and transition to faster processes.

The confirmation issue will be further exacerbated by the need to process allocations. A single trade from an asset manager may well be broken into multiple trades to allocate to underlying funds. This adds additional volume and complexity, potentially occurring late in the US trading day, and presents further operational and settlement risks for Market Participants.

Cut-off times

Executing FX transactions associated with US Securities transactions may occur at times (e.g., 4PM EST) for which settlement is prevented by local currency cut-off times. A clear understanding of the interaction of cut-off times, correspondent banking networks and potential regulatory requirements around payments of currency will become increasingly important and require careful consideration.

Operational Concerns

As there is a risk that FX associated with US Securities settlement arrives later in each day and pushes more volume into the T+1 Settlement window, there will be an increased operational risk around account funding and co-ordination, confirmation matching and exception management processes.

Firms may wish to consider the impacts on operational teams covering the US time zone. In particular, non-US firms may have smaller operations teams in place to cover the US time zone when increased FX flows are expected. Steps may need to be taken to enhance the size or capabilities of these teams.

Future Implications of the Move to T+1 Settlement for Securities

The move to T+1 Settlement (and T+2 for Securities transactions priced after 4:30 EST from T+4) is part of a trend where the SEC has, over three decades, promoted the shortening of the settlement cycle, most recently involving the transition from T+3 to T+2 in 2017. The SEC considered T+0 as a proposed settlement date but has stopped at T+1 due to the many issues presented.

The SEC believes that a further shortening of the settlement cycle would **promote investor protection**, reduce risk, and increase operational efficiency.

The points above highlight the need for greater automation in settlement processes, overcoming the existing challenges in timely confirmation, allocation, exchange of settlement instructions and payment mechanisms. Technologies such as DLT or other immutable electronic mechanisms may become increasingly important going forward. Regardless of the technology that emerges, it is likely that FX Market Participants will need to strive for very high levels of automation, straight-through processing, effective funding prediction, PVP mechanisms and connectivity to other FX Market counterparts to meet the future challenges of decreasing settlement windows.

How to Prepare for the change

Firms may wish to consider the following steps to prepare for the move to T+1 Settlement in the US Securities Market.

- Maintain a focus on likely closing balances at end of day and pre-fund as much as possible before the Market closes in the US.
- Discuss in advance with custodians, as this may be a solution for a number of investors, however pricing may be a concern.
- Review existing flows and sources, (i.e., Types of counterparties) to establish the degree of potential increase in demand from customers.
- Review operational procedures, controls, and staffing levels (particularly consider staffing levels in the US) to ensure the increased volume of T+1 Settlement can be managed.
- Review Cut-Off times in relation to likely changes of trading patterns of existing and target clients and ensure trading considers settlement implications when pricing trades around the end of the day.
- Consider bilateral netting arrangements and procedures to ensure optimal use of funds.

In summary, there are many risks inherent in this process, and Market Participants are encouraged to review their own processes and likely flows. They should also engage with their Market partners to understand the costs of any failures due to errors, given the shorter window allowed by T+1 settlement.

This ACI FMA Briefing Note was produced by the

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