FXPA Buy Side Guidance in Preparation for T+1 Settlement

November 2023

The Foreign Exchange Professionals Association (FXPA) convened a T+1 Settlement Working Group in mid-2023 to discuss the potential FX implications for buy side traders when US and Canadian equities move to T+1 settlement in May 2024. The following guidance was jointly developed by members of FXPA's T+1 Settlement and Buy Side Working Groups to provide a framework of voluntary, non-binding recommendations that assist in preparations for the move to T+1 settlement next year.

Introduction

U.S. Securities settlement will move from T+2 to T+1, effective May 28th, 2024. This is part of a gradual global shift towards shortened settlement cycles. India has already adopted T+1. Canada and Mexico intend to implement T+1 in May 2024, and others in Europe and the UK are also giving this consideration.

For Foreign Exchange participants, T+1 increases the chance that transaction funding dependent on FX settlement may not occur in time, especially during busy periods. Firms should consider the potential increase in operational risk across all aspects of their FX trading processes, including sales, trading, pre-, and post-trade operations, payments, and settlement.

In September 2023, FXPA held a roundtable discussion with the Global Financial Markets Association's Global Foreign Exchange Division (GFXD) to consider the FX implications of the move to T+1 settlement for buy side traders. With feedback from buy side attendees, FXPA has drafted the following guidance to help buy side firms prepare for the transition to T+1 settlement.

Pre-Trade Considerations

- Firms should ensure that any new accounts are fully "onboarded" and enabled for FX trading and settlement with their counterparties before any trading commences, to mitigate settlement risk.
- Firms that previously did not have ISDA/CSA agreements in place with their counterparties should review whether these are now needed in order to process and settle T+1 dated transactions.
- Firms that rely on Straight-Through Processing (STP) of FX Orders into e-Trading venues should review whether their pre-trade netting logic needs to be adjusted. FX Traders may need to net orders based on bank/custodian settlement capabilities, geographic location and/or cut off times.
- Firms should assess the credit lines, banking, and overdraft facilities they have in place and what funding is already committed. Banks could reduce facilities if funding is tight during busy periods.
- Firms should review if a Night Desk, or a physical North American presence is needed to manage settlement risk and cover any unexpected extensions to normal FX trading and settlement hours.

- Firms should consider how any unexpected external events or third-party failures could impact their ability to successfully process FX transactions and complete T+1 settlement.

Trading Considerations

- T+1 could lead to extended FX trading hours and liquidity shortages. Firms should review existing trading relationships to optimize liquidity during busy periods. For example, firms that trade MOC (Market On Close) orders in US equities will need to consider how best to complete the funding FX trade. The trading window effectively becomes the time after the 4pm MOC occurs and before 6pm (if the trade is to be settled before the CLS deadline). This 4pm-6pm window is typically when liquidity is thin, especially on Fridays, month- and quarter-end, and market holidays, which could lead to significantly increased volatility and wider spreads.
- Firms that program trade should consider the impact of T+1 cutoff times on their trading programs and whether program trades need to be completed earlier in the day than was previously necessary.
- Firms should consider how best to process bulk transactions to mitigate settlement risk for T+1 FX trades. Possible approaches could be to:
    - Transact a series of "sweep trades" throughout the day to clear most FX exposures more quickly.
    - Process one bulk FX trade on T+1, then a "true up" trade on T+0. Traders could then settle most of their FX via CLS, with any small balances booked outside of it.
    - Pre-Fund FX for T+1 transactions. This avoids the need to try to locate liquidity and settle FX for T+1 value, although there are extra costs involved.
- Firms should consider whether they have sufficient time to process T+1 trades booked at the WM and/or BFIX London 4pm Benchmarks. Spot Fixing trades will require secondary forward point adjustments to T+1 value.
- Rollover of FX positions may need to be carried out earlier, so that any P&L can be reinvested in the underlying securities on the same day.
- Corporations with public financial reporting deadlines should consider whether the move to T+1 settlement (and the potential increase in market volatility at certain times) could impact their ability to ensure correct FX settlements and flows, including managing issues in a shorter window where key cutoffs can affect public financial reporting (quarter ends).

Post -Trade Considerations

- Firms that trade on a "holding" account and then post-trade allocate (PTA) should determine whether they need to split transactions into those that need to be PTA'd earlier in the day (to accommodate counterparties/custodians that struggle to meet T+1 processing deadlines) and those that can be PTA'd later in the day (with counterparties/custodians that have efficient T+1 processes).
- Firms should discuss with custodians their processing capabilities and cutoff times.
- Firms will need to identify any changes needed to adapt their existing fund settlement cycle to T+1 and ensure they have adequate funding in place to meet increased demand to settle T+0 trades outside of CLS.
- Firms should continue to engage in dialogues with their counterparties, custodians, and settlement and clearing service providers. CLS Participants should continue to monitor whether any extensions to the CLS Real-Time Gross Settlement operating hours are likely to be granted.

- Firms should review post-trade correction and cancellation processes through both their FX trading venues and their own internal Order Management Systems to ensure that they are adequately prepared for mitigating potential T+1 issues.

Conclusions

- The introduction of T+1 is not intended to increase FX settlement risk. However, that could be the unintended consequence if market participants are not fully prepared.
- FX Traders should conduct a full review of the scale of the challenge of T+1 for their FX trading businesses, considering trading relationships, credit, operational processes, funding, and settlement. Strategically, this may present an opportunity for firms to review the greater impact of an accelerating settlement cycle across asset classes.

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