Managing the FX challenge for T+1

As firms prepare for T+1 in May 2024, DTCC's Val Wotton says they should also consider the complexities for cross-border trades.

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As T+1 settlement in the US inches closer to its May 2024 implementation, it is essential that firms ensure a vigorous and synchronized testing program is in place to verify that they can operate successfully within the new compressed settlement timeframe.

Based on early indications we are seeing within the Depository Trust and Clearing Corp.'s (DTCC's) testing program, which was launched on August 14, 2023, firms are increasingly leveraging the industry's environment to administer end-to-end post-trade testing and to assess readiness.

While it is encouraging to see that firms around the world are ramping up efforts to ensure that their systems and post-trade processes are fit for purpose for the May implementation date, organizations must also consider the complexities around cross-border trades, including the impact of time zone differences on foreign exchange (FX).

There have been extensive firm-level discussions across the industry contemplating the various courses of action to manage the time zone issue, given that the time to settle trades will be cut to one business day or less. In the same vein, firms are also closely examining FX risk, as funding for US trades will need to happen within T+1 timelines.

FACILITATING FX SETTLEMENT

The move to T+1 settlement for equity trades means that FX processing must be executed on trade date (T+0) or in the early morning of settlement date (T+1). For cross-border trades, this could be challenging because foreign investors are only able to determine the actual amount of US dollars to be purchased upon confirmation of the trade. At the same time, the FX challenge also creates settlement risk, as foreign investors selling their local currency may not receive the US dollar equivalent to finalize the transaction on time.

In today's T+2 environment, cross-currency settlement is addressed when FX trades are processed within the Continuous Linked Settlement (CLS) system, mitigating settlement risk and improving operational efficiencies. If FX trades cannot be processed and settled in the CLS system to meet the demands of T+1 settlement for equity trades, foreign investors may choose to leverage bilateral settlement, which can be more expensive for currencies that are CLS-eligible, such as the US dollar. This funding option could expose foreign investors to counterparty and settlement risks, as well as negate the benefits of CLS' multilateral netting mechanism.

PRE-FUNDING OF TRADES

Funding of trades generally happens after the trade matching, allocation, confirmation, and affirmation processes are completed, since the exact amount of the transaction is known at that point. With the compressed T+1 settlement window, there is concern that foreign investors could be forced to pre-fund their trades, potentially creating additional costs or requiring changes to their funding strategies.

Since some emerging markets in Asia may not permit the free flow of their currencies, FX trading for non-CLS eligible currencies can only be traded onshore. This may mean that the time needed to process both FX and equity trades could take more than one day. Foreign investors may consider pre-funding to settle trades in local currencies given settlement time constraints. This is not an optimal option, as aside from the additional incurred cost of trading, there is also the stress of allocating sufficient cash reserves.

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IMPLEMENTING CHANGE MANAGEMENT

To address the FX challenge, foreign investors should take a holistic and well-coordinated approach to harmonize the execution of both FX and equity trades to ensure timely settlement. A comprehensive review of existing processes can help to inform decisions. For example, FX fulfillment should be given top priority during local operating hours in Asia to ensure timely FX settlement.

Additionally, Asian firms with a global footprint could consider implementing around-the-clock support across continents or extend coverage during US operating hours to facilitate processing and on-time settlement of FX and equity trades. One ideal solution would be for firms to integrate automated processing of FX and equities trades on one platform to address cut-off time concerns. Additionally, leveraging up-to-date electronic standing settlement instructions (SSIs) from an online global, golden-sourced database can support timely transaction settlement and minimize trade exceptions or fails due to incorrect data.

When India moved to T+1 in several phases starting in February 2022, industry participants explored solutions to address the shortened processing window and mandatory pre-funding concerns. While India did not turn into a mandatory pre-funding market post T+1 implementation, what we learned from India's financial markets is that it is up to foreign investors to work with their intermediaries, including global and local custodians and banks, to agree on the most suitable approach to meet their FX requirements.

Considering the idiosyncrasies of each local market, an industry-wide solution to manage FX trades may not be feasible at this point. The takeaway from industry discussions is that foreign investors should collaborate with their custodians and FX providers to develop a multipurpose solution. To mitigate risks, these resources should possess basic currency management criteria, including operating facilities in key trading locations, 24/5 access to wholesale FX pricing, and liquidity management capabilities. At the same time, firms should assess whether increased levels of automation can help accelerate the FX lifecycle. Doing so will help firms best prepare for the May 2024 implementation date.

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