Foreign Exchange (FX)

Market liquidity / Practices

01 How ready is the FX market going to be for T+1 FX settlement?

At present, the focus is on the significance of T+1, emphasizing the need for real-time operations internally and in coordination with counterparties and asset services.
There's a misconception surrounding T+1 for the US and Canadian markets, with some assuming it only applies to securities like equities and bonds. However, it's becoming clear that FX has risen to the top of the priority list, transitioning from T+2 to T+1. The extended timeframe during the day is noteworthy, particularly as the US market concludes its full trading day.
After 4pm, New York time, there's a noticeable decrease in real FX liquidity. This underscores the need to work in real time with clients and custodians, emphasizing the importance of having technology in place rather than relying solely on labor. There will be a temporary labor component initially for the T+1 phase, gradually transitioning to a more streamlined approach to handle exceptional situations that may arise.

Reflecting on the T+1 journey as a community, there's a scheduled focus on testing in the US, Canada, and Mexico. Initially, the implications of T+1 on Europe and Asia unfold, particularly concerning assets traded outside their domestic locations. The understanding of these implications is more robust in North America but is gradually expanding in Europe and Asia.

Both the buy-side and sell-side are realizing the need for substantial community preparation, considering factors like ethics. From an operations perspective, the emphasis is on working at T0 to streamline processes, minimize file numbers, and ensure efficient handling of end-client requirements.
When considering the practical aspects of how ready the FX market is, individuals might wonder what steps they need to take to be prepared. To address this question, it's essential to break down the process, including the securities trade and FX trade processing. For FX trades to move forward after the agreement, compliance checks are crucial, and various processes need to unfold. Examining current processes to identify time-consuming steps and considering adjustments is key. Organizations have internal cut-off times and aligning them with the cut-off times of custodians or banks is essential. It's crucial to think practically about the entire process and understand each step to ensure readiness for the impending changes.

Addressing the readiness of the FX market for upcoming changes, there are various areas of discussion within the industry to prepare. Observing the shifts in client trading behaviors is crucial, especially considering a one-hour window after the equity market closes at 4pm for executing a T+1 FX winning trade.

This window is expected to be highly compressed. If there's a significant change in trading behaviors during this evening time, liquidity may improve, influencing banks to adjust market making flows accordingly. However, the adherence to CLS cut-offs and the 6pm CLS deadline could become challenging, potentially leading to more bilateral settlements and increased settlement risk. Buy-side firms need to be aware of these potential changes and incorporate them into their considerations.

01 What are some of the issues FX market participants are concerned about with regards to settlement following the move to T+1?

The crucial consideration here is how the buy-side currently handles their FX transactions. In a T+2 settlement environment, if both security and FX trades occur simultaneously, they settle on T+2. However, as the settlement cycle shortens to T+1, there are opportunities to continue settling through CLS, which extends settlement times up to midnight CT on the day before the transaction's value date. Those already executing FX trades on both sides (buy and sell) within the T+2 framework can still do so in a T+1 environment and leverage CLS for settlement.

The challenge emerges when securities are executed first, and FX follows on the next day. In the T+1 world, this method works well as it can still settle through CLS, helping to mitigate settlement risk and provide associated benefits. However, in a T+1 environment where security and FX execution occur on T+0, it may not fit within the CLS settlement window. This presents a significant challenge, and market participants are exploring various tools and strategies to adapt and continue mitigating settlement risk through CLS.

02 Are there any catches or sticking points for participants?

Examining the FX market's preparedness for a specific challenge, signs of increased attention from the buy-side emerged about a year before the deadline. Initially, the sell-side perceived the situation as routine, but the growing vocalization of concerns by the buy-side expanded discussions to include both market segments, highlighting the broader impact. Doubts linger regarding the market's readiness, emphasizing the absence of a straightforward solution.

Within the context of a compressed timeline, challenges related to trade execution are clear which raises considerations about the optimal timing for trade execution. Various institutions are actively exploring solutions tailored to their unique capabilities, technology impact, and cost considerations. Despite the imminent deadline, expectations are tempered, recognizing that a perfect solution might not materialize by the end of May, necessitating ongoing efforts.

Looking ahead, Europe and the UK are moving in a similar direction, albeit on a longer timeline and with nuanced considerations. The need for a short-term tactical solution is emphasized, coupled with the recognition of a necessity for a strategic, long-term solution to effectively address the impending challenge.

There's a sense that the conversation will intensify leading up to the beginning of next year. Industry bodies and associations have been vocal, and it's anticipated that there will be increased pressure and lobbying on that day.

There's a possibility of seeking an extension or temporary reprieve, depending on various influencing factors, though specifics are yet to be determined. Questions about potential changes in current processes are being raised but time is running out to fully formulate and implement any solution.

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04 If the CLS cut off is around 23:00 CET , how are we meant to keep netting our FX? Does this just mean that we're going to have to do everything on a gross basis?

The key deadline for our market is midnight CET, allowing trades to be accepted until then for settlement the next day. A feasibility study is ongoing to explore the possibility of moving this deadline, with discussions involving key associations across Europe, the US, and Asia. However, the process involves more than just adjusting system settings.

At midnight, a multilateral netting process is run, followed by an additional liquidity tool step, increasing efficiency to over 99%. If the timeline is moved, everything needs to shift to the right, impacting member processes.

A working group is internally assessing the impact and risks. The consultation with members is ongoing, exploring possibilities like moving the timeline by 30, 60, or 90 minutes, assessing potential impacts. Responses are being collected and will be analyzed to understand variations among banks. The process aims to ensure that any adjustments don't introduce risks. Results will be published, and if feasible, regulatory approval will be sought, acknowledging the complexity of involving numerous participants and moving parts.

While we have some initial input from members, a key takeaway is the need for further analysis. There's a notable distribution of opinions among members, with some believing there will be no impact, while others think the impact could be significant. Understanding these divergences is crucial, examining if certain members have missed aspects or if others are overcomplicating the situation.

The responses to moving the timeline by 30 minutes appear more positive than those for a 90-minute shift. This variance is expected, considering the established processes, technology, and operational aspects that have been in place for two decades. Drawing conclusive insights at this stage is challenging, given the diverse survey responses.

05 What is the latest update on the consultation for CLS to move their cut offs for USD?

The real deadline for submissions is midnight CET (Central European Time), which corresponds to 6pm ET, factoring in the six-hour gap. Despite adjustments for daylight saving time, we adhere to a CET calendar, emphasizing the importance of submissions by midnight CET.

06 How is it going to be when there is a local currency is facing public holiday on T+1 which would give a short turnaround to initiate FX settlement?

Non-US investors would need to pay special attention, and the proposed solution is pre-funding. This involves ticketing the FX trade ahead of the equity trade, a practice already in place in certain markets like Stock Connect. For markets with Sunday settlement, clients will need to be vigilant about public holidays and prioritize pre-funding to manage T+1 effectively.

Clients not inclined to deliver trades on T+1 have alternative FX options. One option is to establish a US desk or a night shift desk to execute either a T+1 spot trade within the one-hour window after the equity market closes or execute a seven-day spot trade after the FX rollover around 5 pm New York time. Another option to discuss is passing on the FX funding to the custodian, offering various available solutions, particularly for end-to-end FX services. For clients unwilling to pre-fund, an alternative approach is to execute equity trades earlier within the trading range, completing the FX funding before the 4 pm equity close.

07 It's looking like there will be a 'golden hour' of FX liquidity around 5pm ET. Are there any other solutions emerging to handle this other than by moving our FX desk to the US?

Exploring options, opening an FX desk for the US market is an option, but outsourcing is a more economical alternative. Emphasizing the sustained demand for liquidity post 4pm, the anticipation is for supply from custodians, exemplified by Citi and State Street FX. There is a challenge for the buy-side in adjusting trading behaviors. Potential solutions include planning trades earlier, considering credit lines with counterparties, and exploring bilateral arrangements.

Some buy-side firms without a US FX desk are already considering opening one, indicating a real trend in that direction. This raises the idea of opening credit lines with counterparts as a short to medium-term coping strategy. Different coping mechanisms and strategies are expected to emerge over time, with close collaboration with custodians for extending credit lines as an initial measure. As liquidity patterns unfold, diverse strategies will likely come into play, ultimately shaping the final solution based on the collective dynamics of supply and demand within the marketplace.

08 I don't want to pre-fund my trades – from both a risk and cost prospective. What advice do you have?

Changing trading behavior is seen as the least attractive option currently. Custodians and bilateral arrangements with sell-side counterparties are potentially the best option, with future opportunities emerging from discussions with electronic platforms, creating more competition for better spreads, better liquidity and price execution. The challenge arises when dealing with custodians based in the Asia market with a US trade occurring later. From a user standpoint, readiness depends on the custodian's service offering.

09 What are custodian cut-offs likely to look like for FX after T+1 goes live?

It's highly unlikely that custodians will worsen existing cut-offs. However, there is a need for custodians to review cash cut-offs in preparation for the upcoming change, and I would expect these cut-offs to evolve. While there are dependencies, there is room for improvement in the cut-offs, and efforts should be made to achieve that improvement.

Custodians traditionally accustomed to T+2 in FX may not be automatically prepared, placing more responsibility on the buy-side. The complexity lies in digital reconciliation, mapping at the account level, and the need for real-time transparency. While custodians and sell-side counterparties have the tools to meet demand, the buy-side may lack full transparency. The gap in addressing scenarios where FX standing instructions change or adjust is a key concern. Collaborative efforts with various entities, including electronic management platforms and FX providers, are underway to bridge this gap and ensure comprehensive understanding and readiness on the buy-side.

10 We also have some system limitations on how fast trades can be booked as they go through post trade compliance. So on large volume days it can take an hour to book trades after US close. What can we be doing to help prepare given these limitations?

To prepare for the discussed changes and challenges, organizations are advised to conduct tests simulating high-volume scenarios. Emphasizing the importance of collaboration, the recommendation is to work with friendly custodians and clients to mimic peak volumes, improving understanding of operational processes. The focus should be on practical measures rather than fear and doubt. Analyzing past volatile market periods helps identify bottlenecks, providing empirical insights for informed adjustments to operational processes and IT infrastructure. The key message is to proactively gather real facts through testing to enhance processing efficiency in compressed timelines.

This is a moment to consider process reengineering, identifying preemptive checks or investing in automation to enhance operational efficiency. We should evaluate the possibility of investing in automation to expedite checks and improve the speed of FX processes. Exploring third-party vendor tools for increased automation is another option to streamline the effects processing workflow, with the overarching goal being to accelerate the entire process.

Process reengineering is crucial, and to be aware of the fallacy of excessive checks as an illusion of control. Stress testing, both in-house and with counterparts, is a must . Aggregating securities-related trades for T+1 obligations, analyzing FX standing instructions, and understanding the volume scenarios all need to happen. This in-house analysis will serve as a foundation for considering alternatives and technologies, such as real-time automation, to streamline processes. The overarching message is that with demand, the supply will follow, alleviating concerns in the market."

11 What can FX market participants do to mitigate the impact of T+1 on settlement?

Operational efficiency is crucial, and having a US office can be beneficial. Some companies consider pre-funding as an option, but it can be challenging. Many clients aim to maintain settlement flexibility within CLS. They estimate their FX requirements on T+1 to ensure CLS settlement, and on T+0, they confirm the figures. While some risk remains outside of CLS, it tends to be relatively small. Feedback varies among companies in how they approach this. CLS currently supports T+1, which covers about 2.6% of the overall flow when transitioning from T+2 to T+1. The main challenge lies in the shift from T+1 to T+0.

12 If I outsource FX to my broker, how can I be confident of meeting best execution rules?

When considering outsourcing to brokers for optimal execution, it's essential to take specific steps. First, examine their best execution policies and ensure that your own execution standards are integrated into your agreement with them. Implement random audits to verify compliance. Encourage brokers to use multiple liquidity providers and explore different options to avoid being limited to just a few providers, as this can impact liquidity, particularly after market hours. Additionally, consider using third-party benchmarking to assess the performance of outsourced brokers. If this approach isn't satisfactory, custodians may also offer FX-related solutions.