Tokyo Foreign Exchange Market Committee
T+1 Working Group

February 2024

Report on US Securities Settlement T+1

1. Introduction

This report was prepared with the aim of organizing the response status of domestic market participants regarding the shortening of the stock settlement cycle scheduled for May 2024 in the United States and other countries (hereinafter "US securities settlement T+1"), led by the Tokyo Foreign Exchange Market Committee (TFEMC) T+1 Working Group to promote a sufficient understanding among a wide range of market participants trading in the Tokyo foreign exchange market regarding the impact on foreign exchange transactions, market functions, etc.

As the TFEMC, we hope this report will facilitate an understanding of the trend in the move to the T+1 settlement cycle in the United States and other countries, as well as its impact on the Tokyo foreign exchange market, and contribute to the smooth transition of foreign exchange trading practices. The readiness survey of how Japan's market participants are preparing for T+1 was conducted with extensive cooperation from the Investment Trusts Association and the Japan Investment Advisers Association, and responses were received from numerous market participants. We would like to take this opportunity to express our heartfelt gratitude to all parties involved.

2. Issue Awareness

The US Securities and Exchange Commission (SEC) has decided to shorten the current settlement cycle from two business days (T+2) to one business day after the trade date (T+1) through the rule amendments in February 2023 in order to reduce securities settlement risk. In response, starting from May 28, 2024, the stock settlement cycle in the United States is scheduled to transition to T+1. This transition is expected in Canada and other countries, and similar considerations are underway in the UK and EU.

Many overseas investors, including Japanese investors, invest in US stock, and the US dollars required for settlement are generally financed in the foreign exchange market. In this regard, the shortening of the settlement cycle prompts a reconsideration of foreign currency funding policies. Depending on the changes in market participants' foreign exchange trading policies, it could significantly impact the entire foreign exchange market. Particularly regarding US dollar funding policies, the impact on market participants in Asia, including Japan, is expected to be more significant because of the shorter time between the closure of the North American market and the opening of their home markets due to time zone differences.

Regarding foreign currency funding after the transition to the T+1 settlement cycle, the current practice is that foreign currency is transferred only after the required amount of the currency for US stock trade gets fixed. If this policy continues, so-called spot trades, where the execution date and settlement date are the same (hereinafter "T+0 FX trades"), are expected to increase. To avoid T+0 FX trades, foreign currency transactions are anticipated to be conducted ahead of time (commonly called pre-funding).

If T+0 FX trades become widespread, (1) there is a potential for market liquidity deterioration and price formation inefficiency in FX markets in consideration of the current trading volume and liquidity of the Tokyo foreign exchange market. Also, (2) the need for operational processes for settlement to be carried out in a short period and different administrative flows from normal PvP (Payment versus Payment) settlements raises concerns about increased operational risk (such as settlement failures due to administrative delays). Furthermore, (3) there are concerns about increased FX settlement risk associated with the rise in non-PvP settlements.

Taking these potential risks and impacts into account, the Tokyo Foreign Exchange Market Committee established the "T+1 Working Group" (See Appendix A for members.) under its umbrella in August 2023 and has been working to understand the impact of the transition to the T+1 settlement cycle on the Tokyo foreign exchange market. Specifically, a readiness survey was conducted with investors and asset managers who require foreign currency funding in conjunction with investments in US stocks ("buy-side"), as well as with foreign exchange banks engaged in currency trading ("sell-side"). The efforts of a wide range of domestic market participants were confirmed through aggregation and analysis of the results. Below, we would like to report on the current response status and where the risks lie based on the survey results.

3. Overview of the Readiness Survey

The readiness survey was conducted in November 2023, targeting Tokyo foreign exchange market participants expected to be significantly affected by the transition to the T+1 settlement cycle in the United States. Two types of questionnaires were prepared, one for the buy-side (domestic asset managers, investment advisers, institutional investors, etc.) and one for the sell-side (banks and security houses affiliated with the TFEMC), and obtained responses from both sides. In terms of content, efforts were made to aggregate information on opinions and requests toward the sell-side, buy-side, and trust banks, which serve as counterparties to transactions, in addition to their response status and future response policy. Responses were received from 152 buy-side firms (70 of which handled foreign stocks) and 12 sell-side firms.

(Detailed results are provided in the attached materials.)

4. Summary of Readiness Survey Result

An overview of the survey results shows that the majority of market participants on both sell-side and buy-side firms were already aware of the outline and related risks of the US securities settlement T+1 at the time of the survey, and progress in considering necessary countermeasures was noted (see sell-side results: Page 7, Section 1 (1) (2); buy-side results: Pages 25-26, Section 1 (2) (3)).

Looking at buy-side responses regarding foreign currency funding after the transition to the T+1 settlement cycle in the United States, while an increase in the number of T+0 FX trades is anticipated, responses indicating reliance solely on T+0 FX trades were limited. An expansion in the policy of avoiding a significant increase in the number and volume of T+0 FX trades by utilizing other methods, such as pre-funding, was observed across the entire buy-side (see buy-side results: Pages 31, Section 1 (6) & Page 37, Section 2 (5)).

In this regard, the sell-side results showed that while T+0 FX trades are feasible to a certain extent for most firms, the number of firms considering reassessment of their readiness to enhance their response capabilities beyond current levels was limited (see sell-side results: Pages 10-16, Section 2 (7)).

Based on the overall perspective mentioned above, we would like to report on the various risks anticipated during T+0 FX trades while confirming the response policies of the buy and sell sides and the perception gap between the two through the survey results.

(1) Market Liquidity Deterioration & Inefficiency of Price Formation in FX Markets

The market for T+0 FX trades is relatively small and has low liquidity. Although it is only a rough indicator, Appendix B shows the transaction volume of short-term foreign exchange swaps (USD/JPY) in the Tokyo interbank market provided by the Money Brokers Association. Comparing the size of T/N (Tomorrow Next) transactions used for general short-term funding, with O/N (Overnight) transactions mainly used in the interbank market as cover transactions for T+0 FX trades, the latter is found to be less than 20% of the former (2023 daily average, O/N: approx. USD 3.4 billion, T/N: approx. USD 23 billion).

In this context, as far as the responses obtained from the survey are concerned (see buy-side results: Section 2 (5)-(8)), the anticipated increase in the transaction value per T+0 FX trade is relatively small, and even incorporating the anticipated rise in the number of transactions, the estimated increase is limited compared to the current market size of O/N transactions. For now, it appears unlikely that the T+1 settlement cycle in the United States will immediately have a significant impact on Japan's USD/JPY O/N market, leading to inefficiency of price formation. However, it should be noted that there is a high level of uncertainty, as many respondents were "unsure" about the amount of increase in T+0 FX trades. It should also be fully taken into account that with the limited liquidity of the O/N swap market, price fluctuations are prone to widening, particularly around month end and quarter end, and, depending on supply and demand conditions.

This survey confirmed that approximately 60% of the buy-side participants know the risks associated with the low liquidity of the T+0 FX trades market (see buy-side results: Page 36, Section 2 (4)). Continuing efforts to enhance awareness of these risks are beneficial, and the sell-side firms are expected to strive for appropriate situational awareness and information sharing regarding market liquidity trends related to T+0 FX trades.

(2) Operational Risk

The survey results indicate a growing trend among the buy-side to avoid a significant increase in the number and volume of T+0 FX trades. However, the number of T+0 FX trades is expected to increase for minor cash flow adjustments (see buy-side results: Pages 31-32 & 37, Section 1 (6) & Section 2 (5)).

The increased number of transactions implies that each entity will face a heavier operational burden than the current level. It is observed from the survey results that many sell-side firms intended to set various conditions for smooth administrative processing, such as (i) "pre notice" from buy-side firms before each transaction, (ii) setting the execution cutoff for the T+0 FX trades involving JPY settlement to be in the morning Tokyo time, and (iii) establishing upper limits on the number of orders they can handle (see sell-side results: Pages 34, 36, & 38, Section 2 (2) (4) (6)). On the contrary, the buy-side results are characteristic in the presence of the corresponding number of respondents who do not recognize the necessity of "prior notification" and a significant demand for relaxation and flexibility in trading conditions (see buy-side results: Pages 36, 42-47, Section 2 (4) & Section 3). Additionally, there was a wide-ranging call for efficiency improvements for operations concerning specific monetary trusts, investment trusts, etc. facilitated through trust banks.

If the buy-side proceeds with transactions without considering various constraints associated with the remaining limitations on the sell-side's response capacity to handle T+0 FX trades, unforeseen operational risks may manifest. Similarly, the trust banks' response capacity and various constraints should be considered for transactions facilitated through them.

These various constraints may be alleviated in the future through steady efforts by each entity to streamline and sophisticate settlement practices. Market development, including an increase in transaction size, is also anticipated. However, in light of the survey results, it is crucial for the buy-side, sell-side, and trust banks to closely communicate regarding the anticipated values, frequencies, numbers, timings, and other aspects of T+0 FX trades to bridge any perception gaps among stakeholders from the perspective of proactively avoiding the manifestation of operational risks when the transition to the T+1 settlement cycle in the United States is looming in several months.

As the survey results indicate, both sell-side and buy-side participants have expressed numerous concerns about back-to-back transactions[1] involving overseas investment delegations (see sell-side results: Pages 17-20, Section 3; buy-side results: Pages 42-47, Section 3). Due to the involvement of overseas stakeholders, quick confirmation of execution within short timeframes

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[1] In foreign exchange operations facilitated through Japanese trust banks, when the entity entrusted with investment management overseas conducts currency transactions with financial institutions outside Japan, the financial institution typically processes back-office-related tasks with the trust bank through its Japanese branch (back-to-back processing). After transitioning to the T+1 settlement cycle in the United States, if overseas investment trustees align the settlement timing with securities settlements using T+1 FX trades, short processing time from execution reconciliation to settlement at essentially T+0 timing is expected to be required in Japan.

is prone to be difficult, and there may be a need to process a higher number of transactions than anticipated without prior communication. Therefore, in this scheme, it seems crucial to ensure shared understanding when communicating among stakeholders, including overseas investment delegations.

(3) FX Settlement Risk

Foreign exchange settlement risk is the risk in foreign exchange transactions where one party delivers the sold currency but does not receive the principal of the bought currency due to the counterparty's default or other reasons. In order to prevent such a risk from materializing, PvP settlement[2] is promoted for many foreign exchange transactions, including trust accounts. As a principle of global foreign exchange market practice adhered to by many market participants, the FX Global Code (established in 2017, revised in 2021) explicitly states the importance of utilizing PvP settlement whenever practicable and guides foreign exchange settlement risk management in cases where PvP settlement is not utilized (Principles 35 & 50).

In this regard, when conducting T+0 FX trades, foreign exchange settlement risks are more likely to manifest due to the difficulty of utilizing PvP settlement through CLS Bank. In this survey, following the increase in operational risk, a significant number of respondents from both the sell-side and buy-side have pointed out the escalation of foreign exchange settlement risk as a concern related to the transition to the T+1 settlement cycle in the United States (see sell-side results: Pages 8-9, Section 1 (3); buy-side results: Pages 27-28, Section 1. (4)).

Measures to avoid T+0 FX trades are under consideration on the buy-side, including a method in which custodians handling securities settlement conduct foreign exchange transactions (so-called Custody FX), consulting individual securities firms for irregular arrangements to extend the securities settlement cycle to T+2, etc., while focusing on utilizing pre-funding (see buy-side results: Pages 31-32, Section 1 (6)). It deems necessary to consider the merits and demerits of various measures while keeping in mind not only operational risk but also foreign exchange settlement risk.

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[2] The settlement mechanism conditions payments between different currencies on each other so that the delivery of one currency will not occur unless payment in another currency is made, thereby avoiding the risk of missing the principal.

5. Conclusion

This report examines the efforts of domestic market participants regarding the US securities settlement T+1 while delving into various risks based on the survey results conducted in November 2023. Again, we would like to thank the market participants who responded to the survey and the Investment Trusts Association and Japan Investment Advisers Association for their cooperation in conducting the study.

The shortening of the stock settlement cycle is becoming a global trend, which is also considered in other jurisdictions besides the United States, and discussions are underway to transition to the same-day transaction settlement (T+0). To smoothly adapt to the changes in securities settlement cycles, the overall progression in the domestic market is essential in sophisticating and streamlining settlement systems on the sell-side and trust banks and in promoting understanding and reviewing operational methods on the buy-side. To this end, a thorough knowledge of the various risks highlighted in this report is required.

In this survey, progress in responding to the looming US securities settlement T+1 was noted on both the sell-side and buy-side and a growing trend of avoiding T+0 FX trades was observed, especially on the buy-side. On the other hand, specific perception gaps between the sell and buy sides were evident from the opinions and requests obtained from both sides. Furthermore, it should be noted that many responses on the buy-side indicate a lack of precise understanding regarding the impact of the transition to the T+1 settlement cycle in the United States and the policies for subsequent approaches at the current juncture.

As the trend toward shorter settlement cycles in stocks progresses, efforts for innovation and facilitation of communication among market participants are required to prevent hindrance to global securities investment due to the manifestation of various risks in foreign exchange practices. We hope this report will be helpful to many market participants in their various endeavors. The Tokyo Foreign Exchange Market Committee remains committed to monitoring the trends of domestic market participants regarding the transition to the T+1 settlement cycle in the United States and strives to follow up on its impact on the foreign exchange market.

End of Report

Appendix A: T+1 Working Group Members

Chair: Ryohei Kobayashi	(JP Morgan Chase Bank)
Takayuki Okuma	(Nomura Asset Management)
Takashi Yamamoto	(Mitsubishi UFJ Trust and Banking Corporation)
Shu Nakamura	(same as above)
Kyoko Fukuda	(Australia and New Zealand Banking Group Limited)
Yasutada Suzuki	(Sumitomo Mitsui Banking Corporation)
Kenji Takane	(Citigroup Global Markets Japan Inc.)
Hirotsugu Inoue	(BNP Paribas Bank)
Hidemi Bessho	(Bank of Japan)

Appendix B: Short-Term FX Swap Transaction Volume

(Source: Money Brokers Association survey)

(Average per business day, in billions of USD)

	(1) O/N	(2) T/N
January	4.6	20.9
February	3.7	17.7
March	3.6	24.0
April	3.5	22.9
May	3.0	23.4
June	3.4	18.7
July	2.8	19.4
August	3.2	22.7
September	3.1	22.0
October	3.2	24.4
November	3.0	29.9
December	3.6	31.4