POLICY VIEWPOINT

Impacts of the US move to T+1 settlement in Europe

How to avoid a new Herstatt crisis?

It has been a while since Herstatt risk has been referenced in financial circles and certainly in the mainstream media, however, it is something that the European fund management industry is concerned about as the deadline for shortening the US settlement cycle draws near.

What is Herstatt risk?

Herstatt bank was a German regional bank whose insolvency in 1974 caused a major chain reaction across global payment and settlement systems. The collapse of Herstatt bank was the most severe and dramatic instance of a bank failure which nearly brought down the international banking system. Herstatt risk today refers to the **FX settlement risk associated with dealing FX trades across time zones**.

On 26 June 1974, German authorities closed down Herstatt bank at 4.30 pm local time, leaving large FX operations unfinished. Correspondent banks in New York had paid Herstatt in US dollars but had never received the Deutche Mark payments in return. The panic and contagion that this event caused resulted in the suspension of the global clearing system (Clearing House Interbank Payments Systems, CHIPS) and it contracted the efficiency of cross-border settlement for months afterward.[1]

The Herstatt incident led to the creation in 1975 of the Basel Committee (BCBS) to improve international cooperation and oversight of financial institutions.

CLS Bank International

The single biggest reason why Herstatt risk is seldom mentioned today is due to the innovation of CLS Bank International. CLS Bank was set up in 2002, as a private sector initiative, by a number of large global banks. Today CLSSettlement operates as a financial market utility, mitigating settlement risk for market participants. It supports 18 different currencies and handles a daily flow of transactions worth USD 6,5 trillion.

[1] https://academic.oup.com/ehr/article/129/540/1129/2769724

How does CLSSettlement reduce settlement risk?

The Herstatt risk identified above is largely removed by CLS as it operates a so-called Payment versus Payment (PvP) system. Under PvP, two counterparties to a trade exchange payments simultaneously, meaning there is no risk that one leg of the trade settles, while the counterparty to the other leg defaults. The PvP feature, therefore, mitigates settlement and counterparty risk. **CLS relies on a time window when all major central banks' RTGS (real time gross settlement) are operational to enable simultaneous settlement across all participants.**

In addition to mitigating settlement risk, CLS has other important benefits. It offers **funding** and **operational efficiencies** through the netting benefits of settling through a single platform. Client balances are multilaterally netted which has significant funding benefits – CLS report this reduces the daily USD 6.5 trillion settlement requirement by 96%, meaning that only USD 65 billion actually exchange hands.[2]

FX settlement in times of market stress

In times of extreme market volatility, there will be major spikes in demand for FX, such as seen during the Lehman Brothers crisis or more recently during the Covid crisis. In these periods of market stress, the role of CLS is critical to ensure timely settlement, and to reduce the required liquidity to settle trades.

What happens after May 2024?

When the US shortens its settlement cycle to T+1, certain segments of the market, including European asset managers, will have a very ljmited ability to access CLS for their USD trades. The reason is simple. Asset managers trade throughout the US trading day, with a significant part of trading coming on market close (4pm Eastern Standard Time). By the time an asset manager has confirmed the trade and is ready to execute the FX, there is little time, if any, to submit the FX trade to CLS, which has a cut off of 6pm EST. Under these circumstances, **CLS access is significantly reduced**, if available at all.

When US securities still settled on T+2, the issue of PvP netted FX settlement did not arise as there was an additional day in which to submit trades for settlement on the CLS platform.

The inability to use CLS pushes asset managers into costlier and riskier alternatives:

- prefunding (i.e. holding USD cash buffers) which are an inefficient use of capital
- operationally complex FX on trade day with a 'true-up' required the next day against the confirmed trade
- bilateral settlement with the counterparty bypassing CLS altogether

Up to 40% of asset managers' daily FX trades will no longer settle through CLS

In Q1 2024, EFAMA surveyed its member firms to determine the percentage of current FX trades (with a USD currency pairing) which would not be eligible for CLS settlement due to the inability to meet an internal custodian deadline , itself set against the official CLS cut-off 6pm EST.

The results were in line with what this industry has feared since the US T+1 move was announced. Well over 1/3 of FX trades (38.5%) would have to settle outside CLS according to estimates by fund managers, based on their trading patterns and their custodial relationships.

[2] https://www.cls-group.com/media/ruxdgeyd/cls-shaping-fx-03-liquidity-benefits_do_not_settle_for_less.pdf

Custodians themselves displayed a wide range of cut-offs. There were two major time clusters where cut-offs were applied, **either around 6pm CET** (indicating a European business day imposed cut-off and well ahead of CLS's cut-off which comes at midnight CET or 6pm EST). The **second cluster was around 10.30pm CET** (4.30pm EST), but again with variations around that time.

There is no doubt that custodians could be more aligned in their cut-off times, and the industry average should ideally be much closer to the CLS cut-off.

Asset managers should grin and bear it

On active trading days, due to a major index rebalance or other external events, European fund managers will settle in excess of several hundred USD billion on CLS. **The 40% of FX trades that can no longer access CLS for settlement would be in the region of 50-70billion on normal trading days, and easily double that figure on active trading days**.

Putting USD 50-70 billlion or greater at risk, on a daily basis, in the world's major currencies should be a significant concern. This is of systemic importance. To recall, Herstatt bank was only the 35th largest bank in Germany in 1974, and yet its failed operations very nearly brought down the entire banking system.

CLS itself refers to its business as the 'unglamorous plumbing'[3] which provides the backbone of the financial system, ensuring that money and other assets flow smoothly, safely and efficiently. SEC chair Gary Gensler, has often referred to the US move to a shortened settlement cycle as an upgrade to the most efficient and reliable pipes on the market: copper pipes.[4]

European asset managers would beg to differ. With 40% of our daily FX flows unable to settle safely and efficiently, we see a major hole in the proverbial pipes, even before the valves are turned on.

Without necessary adjustments to make the CLS platform accessible (this will require changes to cut-off times both by CLS and custodians' own internal deadlines), the asset management industry cannot agree that T+1 will make the system 'safer for everyone'.[5] T+1 implementation today does not represent an absolute reduction of risk in the system. From where asset managers sit, it looks more like a shift away from credit and market risk to an increase in operational and settlement risk.

We hope that the SEC and NY Federal Reserve, as well as the ECB, can take a more active role in understanding impacts on settlement risk and to take mitigating measures such as:

- **requiring the extension of the official CLS cut-off time**
- **encouraging the adoption of later cut-offs (more aligned with CLS) by the custodian community**

In that context, it is useful to be reminded of the central bank-led Global FX Code, which cites under its Principle 35: *Market Participants should reduce their settlement risk as much as practicable, including by settling FX transactions through services that provide PVP settlement where available.* [6]

[3] https://www.cls-group.com/media/ma3bsqnc/cls_shapingfx01_causeandfx_april2023.pdf
[4] https://www.pionline.com/regulation/secs-gensler-preaches-shortened-settlement-cycle-benefits-eu-counterparts
[5] https://www.pionline.com/regulation/secs-gensler-preaches-shortened-settlement-cycle-benefits-eu-counterparts
[6] fx_global.pdf (globalfxc.org)

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages around EUR 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the EFAMA Fact Book.

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