Deutsche Bank

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Basel Committee on Banking Supervision
Bank for International Settlements
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Dear Sir or Madam,

Deutsche Bank's (DB) response to the Basel Committee on Banking Supervision (BCBS) on Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions

We welcome the opportunity to provide feedback on the Committee's proposed guidance.

We agree with the overriding principle that banks should manage foreign exchange (FX) settlement-related risks in a way that is similar to the management of equivalent risks of other activities, while taking into account any features that are specific to FX. Regulators, Banks and Financial Market Infrastructures (FMIs) should concentrate their efforts on increasing the scope of currencies, and counterparties that are eligible for settlement through payment-versus-payment (PVP) arrangements.

To date, the FX industry has worked with the Regulatory community to reduce settlement risk, through a number of solutions, most notably the industry initiative that is CLS Bank International (CLS). Deutsche Bank has been a consistent supporter of CLS extending its services to more currencies, participants and to settlement sessions across a wider set of time zones. We have invested in capacity to protect the capability of CLS' infrastructure to manage growing market activity, high volume days and the multiple settlement session initiatives presented by CLS and its partners. We encourage Supervisors and Central Banks to continue to concentrate their efforts on wider participation in PVP arrangements.

We fully support the update of the guidelines and efforts to minimise the risks associated with the settlement of FX transactions. We encourage Supervisors to continue to focus their efforts on the mitigation of FX settlement-related risks rather than the capitalisation of them. Supervisors should take into account the low probability of failures and whether the measures to prevent FX settlement risks are adequate before considering an enhanced capital framework.

Our response is structured around some of the key guidelines and paragraphs of the supervisory guidance. Please let us know if we can provide further information.

Yours sincerely,

Daniel Trinder

Government and Regulatory Affairs

1. Governance

We agree with the Committee proposals for strong governance arrangements that ensure all FX settlement-related risks are properly identified, measured, monitored and controlled on a firm-wide basis.

3.1.9 Selection of appropriate pre-settlement and settlement arrangements for FX transactions: We agree that a bank's risk management framework should include procedures to identify the most appropriate settlement method for each type of FX transaction. However, we note that this is not determined by the bank alone, and flexibility is required to consider client requirements and pre-agreed legal agreements when assessing the most appropriate settlement route.

3.1.12 Dependence on other institutions: We agree that a bank's risk management framework should include policies and procedures for evaluating the risks and benefits of using correspondent banks. We recommend that the operational assessment should consider the relative efficiency of STP processes, the ability to disclose standard settlement instructions (SSIs) on confirmations at the time of trade and the efficiency of funding of the Nostros used. This is due to the different operational models used by backup correspondent banks and the fact that some IT applications from providers have not yet migrated to real time processing. We note that Nostro "risk management" is not a dynamic allocation process and it is prohibitive to switch Nostros in a way that could disrupt, rather than enhance, risk management.

2. Principal Risk

We fully support the Committee's proposals to eliminate principal risk and use PVP settlement where practicable. Management of principal risk is an integral part of DB's overall risk management framework, which is designed to identify, measure, monitor and control risk through, for example, limits on exposure size. DB operates a robust principal risk control framework spanning the lifecycle of each trade. Where practicable, settlement is effected through an FMI (primarily CLS Bank). For non-PVP settlement, limits are defined by counterparty credit risk management and checked prior to trading. Exposure and excesses are monitored and mitigated as required, so that limits are reduced for lesser quality counterparties. We also monitor incoming payments and mitigate failed settlements as necessary. In addition there is an established process for crisis scenarios where action can be taken to alleviate principal risk for distressed counterparties.

Key consideration 1: A bank should eliminate principal risk by using FMIs that provide PVP settlement, where practicable. Where banks apply rigorous risk management techniques with proactively managed credit agreements, for example in cases where DB monitors and requires 'safe or controlled settlement', the use of FMIs may offer no additional benefit in relation to principal risk management. It appears that there is no reference to 'safe or controlled settlement' in the consultative document, as an effective risk mitigation process where payment of currencies is withheld until receipt of the buy currency on settlement date is confirmed.

3.2.8 Measuring expected principal risk: Measuring expected principal risk would require the bank to know the relevant unilateral cancellation deadline for the currency it sold and when the incoming payment for the currency it bought will be received with finality. Currently these are a function of the Nostro banks' ability to consume cancellation messages in either an automated or manual fashion, and so have varying degrees of effectiveness. Generally, universal cancellation deadlines are not automated. The unintended consequence of providing certainty around the cancellation deadline, before fully automated cancellations are an industry standard, are a smaller window of opportunity to cancel and a corresponding increase in the liquidity needs of an

institution, as the flexibility to make late cancellations in the normal course of business will be lost. Any errors on short dated trading, even same day trading, will be exacerbated. This does not undermine the benefits of finality of payment but will, in providing finality, reduce flexibility and liquidity while potentially increasing costs. As with all liquidity concerns this may actually increase the probability of FX settlement risk failures that the unilateral cancellation deadlines were intended to reduce.

3.2.12: Reconciling incoming payments: Including all unconfirmed receipts will overstate the principal exposure and not help focus on the risks being managed. A rigorous risk management framework should differentiate between the credit quality of a counterparty, existence of collateral disputes, geography and the type of counterparty, such that it allows banks to focus on those exposures where a loss is more likely.

3.2.16: Reducing the size of remaining principal risk: We believe banks should be able to measure as net without a legally binding net settlement agreement, as long as a robust exceptions process exists internally in the event a counterparty designated as a 'net settle' chooses to settle gross and the resulting exposure is above limits. In addition, there are many nuances to netting agreements, for example cut-off times and eligible currencies that can cause complications and undermine the relative benefits of such arrangements.

3. Replacement cost risk

We agree that banks should employ prudent risk mitigation regimes to properly identify, measure, monitor and control replacement cost risk for FX transactions.

4. Liquidity risk

In general we support this guideline and the key considerations, but note that the Intraday Liquidity Reserve Deposit (LRD) stresses the currency specific payment risk at a 100% payment obligation. Local stress tests ensure that enough currency specific collateral is held to meet all obligations.

3.4.4 Impact of FX settlement failure: With reference to non-PVP settlement, though notional can be of notable size, the risk of loss is minimal. Furthermore, most FX transactions are settled through CLS. Cross currency swaps and non-CLS settlement exposures are monitored by counterpart and 'safe settlement' can be requested in order to mitigate any payment risk. We hold local buffers and highly liquid collateral that can be easily moved in order to meet any additional margin requirements, as described in 3.4.8.

5. Operational risk

We support the principles set out regarding the management of operational risk.

Management of operational risk is based on a group-wide consistent framework that enables us to determine our operational risk profile in comparison to our risk appetite and systematically identify operational risk themes and concentrations in order to define risk mitigating measures and priorities. The management of FX settlement risk is an inherent component of this framework, which utilizes STP, electronic trade confirmation and standard settlement instructions and ensures systems have sufficient capacity and scalability with robust business resiliency and continuity plans.

6. Legal risk

We support the guideline regarding legal risk and the recommendations as to enforceability in sections 3.6.1, 3.6.2 and 3.6.3, which reflect appropriate internal practices. The guidance in section 3.6.5 should clarify that this section applies to settlement payments, rather than to master agreements and transactions. Typically, legal opinions relating to master agreements and transactions focus on enforceability of set-off and close-out of transactions. Banks should assess the scope and nature of legal advice obtained as part of the settlement process with a goal of being in a position to determine whether they can reasonably rely upon guidance as to the timing of finality of payments under applicable processes. Relevant contractual provisions should be drafted so that a bank has appropriate confidence as to the timing of finality of payments with its counterparties. We believe that obtaining such guidance accomplishes overall goals that include those indicated in Sections 3.6.6 and 3.6.7.

7. Capital for FX transactions

We understand and agree that banks should manage FX settlement-related risks in a way that is similar to the management of equivalent risks of other activities, while taking into account any features that are specific to FX. Management of FX settlement risks are already an important component of DB's overall credit risk management framework, with controls that take into consideration the size of the exposure, nature, complexity and risk profile of the counterparty. We believe Supervisors should focus on the requirements to mitigate FX settlement risks through appropriate risk controls rather than the capitalisation of them. We therefore recommend that this guideline should focus on the ability to control, manage and accurately settle FX transactions and that capital should apply in circumstances where those controls are deemed materially insufficient.