Managing liquidity in a post crisis world

Goldman Sachs European Financials Conference

Michael Reuther | Member of the Board of Managing Directors | Berlin / 13th June 2008
Money market – current environment and expected development

Market observation

› Credit spreads / liquidity premiums remain volatile and at high levels
› Overall reduction in term liquidity
› USD liquidity is increasingly expensive / cross-currency market dislocated (correlation)
› Collapse of ABCP market / consolidation of SIV’s
› Strong and continuous Central Bank intervention but no remedy for disturbed market situation

Lessons learnt

› Credit spreads / liquidity premiums will not decline in the nearer future
› Reduction of term credit lines makes it difficult to place funds with other banks
› Business model has high impact on liquidity situation
› Customer multi currency loan facilities with options to draw in different time buckets (e.g. 1 to 6-M-Libor) are difficult to manage / to be re-priced
Capital market – current environment and expected development

Market observation

- Credit spreads / liquidity premiums remain volatile and at high levels
- Overall reduction of unsecured issuance activities
- Flight to quality
- Pfandbrief and covered bond market affected
- Market for senior unsecured bonds basically open for AA-rated banks

Lessons learnt

- Funding from capital markets possible at a higher cost level
- Distressed market situation on primary and secondary market will remain longer than originally expected
- German Pfandbrief due to high quality in a relatively strong position in the covered bond market
- Business model rather than rating determines funding cost
Central Bank activities during the crisis

**Market observation**
- Additional short-term liquidity provided using the existing framework
- ECB shifts volume from weekly to 3- and 6-month tender operation (30/70)
- Change to “front-loading” for minimum reserve steering by ECB caused larger volatility in interest rates
- Additional longer term liquidity available (LTRO*, TAF**)
- Expansion of eligible collateral lists (BoE, Fed)
- Coordination of cross currency facilities (Fed, ECB, SNB)
- Reduction of marginal borrowing cost and term extension (Discount Window)
- Grant access to more counterparties (PDCF***)
- Abandonment of negative stigma associated with use of Central Banks facilities (especially BoE, Fed)

**Lessons learnt**
- Shift from weekly to 3- and 6-month tender operations to anticipate ECB volume change and increase funding stability
- Pooling of ECB eligible assets within Group proved stability in funding operations
- Renewed test of usability of Discount Window and BoE contingent facility proved to be stable
- Necessity to take up dialogue with Central Banks to further expand list of eligible collaterals (especially ECB) in case of a further market deterioration

* Long Term Repo Operation  
** Term Auction Facility  
*** Primary Dealer Credit Facilities
Commerzbank Group balance sheet shows sound funding structure …

- Total Assets € 616 bn
  - Cash/ interbk. lending & dedicated liquidity portfolio 41%
  - Liquid trading assets/ reverse repos & fair values of derivative hedging instruments 22%
  - Other commercial banking assets & other assets 32%

- Total Liabilities € 616 bn
  - Money market instrum. & liabilities to banks 12%
  - Trading liabilities/ repos & fair values of derivative hedging instruments 23%
  - Non core customer deposits & other liab. 31%
  - Capital/ senior unsecured funding & core customer deposits 31%
  - Covered bonds 31%

- Balance sheet prudently funded
- Core business & assets not liquid within 1 year funded long-term (average term to maturity of bonds 3.4 yrs)
- Remaining unsecured and capital funding calendar until year end 2008: roughly € 5 bn
- Customer deposits on the rise

Dedicated liquidity portfolio and liquid assets larger than short term liabilities
... in all maturity buckets

Unsecured funding matrix

Per 31.03.2008

- Maturing assets > liabilities
- Maturing liabilities > assets

- Sound funding structure also reflected in all maturity buckets
- Term of funding in all buckets longer than maturing assets per bucket
Updated funding plan 2008 – targeted volume reduced to under €25bn

Covered Bonds ~ 2/3

- Hypothekenpfandbriefe: 30-35%
- Lettres de Gage: 10-15%
- Jumbo Pfandbriefe: 20-25%

- Öffentliche Pfandbriefe: 25-30%

Unsecured ~ 1/3

- Capital: 10-15%
- Structured Notes: 40-45%
- Private Placements: 40-45%
- Public Issuance: 0 - 10%

- Pfandbriefe issued via Eurohypo
- Two Euro Jumbo Pfandbriefe
- Lettres de Gage mainly in non-Euro currencies
- Continued utilization domestic and registered Pfandbriefe

- Significant increase of client deposits has resulted in reduction of unsecured capital markets funding requirements
- Benchmark issuance most likely unnecessary
- Limited needs for capital – unchanged
Increased client deposits have eased unsecured funding needs

Client Deposits Commerzbank Group
€ bn

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Q1 07</th>
<th>Q2 07</th>
<th>Q3 07</th>
<th>Q4 07</th>
<th>Q1 08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>69</td>
<td>73</td>
<td>78</td>
<td>81</td>
<td>87</td>
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</table>

Unsecured New Issues
€ bn

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Q1 07</th>
<th>Q2 07</th>
<th>Q3 07</th>
<th>Q4 07</th>
<th>Q1 08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Placements</td>
<td>1.3</td>
<td>3.7</td>
<td>2.4</td>
<td>0.8</td>
<td>2.0</td>
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<tr>
<td>Benchmarks</td>
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Source: Commerzbank Controlling
Source: Group Treasury Database

Increased client deposits have eased unsecured funding needs.
Modification of Commerzbank's liquidity risk management model

**Additional scenarios analysed (e.g.)**
- Loss of interbank deposits
- Disruption of capital market funding
- Pfandbrief stress
- Drawdown behaviour of (un)committed credit lines

**Model adjustment & other (e.g.)**
- Repo and sell off assumptions for balance sheet liquidity readjusted (base and stress scenarios)
- Even more conservative assumption for capital market funding capacity under stressed situation
- Tightening of liquidity risk limits
- Increase in reporting frequency
- Review / adjustment of transfer pricing for liquidity costs
- Moving from a base scenario to a market stressed base scenario

**Conclusion**
- Review / adjustment of transfer pricing for liquidity costs necessary to send the right signals for new business into the organisation
- Integrated credit, market and liquidity risk management helps to speed up the process and define valid assumptions without sending wrong signals into the organisation
- Frequency for review of model assumptions needs to be aligned according to the respective market environment
- Proactive customer relationship management is essential to protect client deposits and even raise additional deposits
Regulatory environment in a post crisis world

Trends and developments

› Supervisors will use Pillar 2 to strengthen banks’ risk management practices
› Supervisors will improve risk disclosure requirements under Pillar 3
› Widening of operational framework for central banks and increasing flexibility (e.g. SNB)
› Efficient and timely exchange of information and cooperation in developing good practices on national and international level
› Call for consultation on Sound Practices for Managing Liquidity in Banking Organisation by June 2008
› German Liquiditätsverordnung and its opening clause for internal liquidity risk models – first certification audits by German supervisor already underway
› Controversial discussion on capital requirement for liquidity risk
› European commission is planning to change the large credit regulation between banking institutions
› Regulation of rating agencies
Commerzbank managing liquidity in a post crisis world

- Gained experience out of 2002 market turmoil on Commerzbank liquidity situation helped building up a proactive and strong liquidity risk management
- Maintenance of high liquidity ratios
- Integrated liquidity risk model at Group level
- Liquidity risk management fully integrated into Commerzbank's overall risk management infrastructure
- General prudent risk management – not only on liquidity risk
- Maintenance of sufficient liquidity buffers at reasonable cost levels
- Stable funding base due to well balanced business model and diversified funding structure
Appendix
Repo market – current environment and expected development

- Overall decrease in liquidity in GC*, but also in specials market
- Experienced break down of bilateral repo market
- Decrease of security pools / for EUR most activity is in ECB eligible securities as dealers can refinance them at the central bank
- Demand for quality enhancement for (tripartty) collateral pools
- Bilateral right for substituting securities (no longer for seller only)
- Increase in haircut to protect against market volatility
- Repo market is trading O/N** and T/N*** above unsecured money market (term open for GC repo)

In a liquidity stress situation only central bank eligible collateral can be seen as really liquid

Adjustment of repo and sell off assumptions necessary to recalibrate our internal model on liquidity risk management

Even for ECB eligible collateral the liquidity spreads have increased significantly in the market

ECB eligible collateral – Eonia spread

<table>
<thead>
<tr>
<th>ECB eligible collateral</th>
<th>3-M-repo rate vs. Eonia</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS</td>
<td>pre suprime level</td>
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<tr>
<td>Financial</td>
<td>current levels</td>
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<tr>
<td>Govies</td>
<td></td>
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<tr>
<td>Pfandbriefe</td>
<td></td>
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<tr>
<td>Agencies</td>
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* General Collateral  ** Over Night  *** Tomorrow Next
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