The way the upcoming Liquidity Ratio is already impacting the business model of banks and some specific views of DZ BANK AG

Michael Schneider

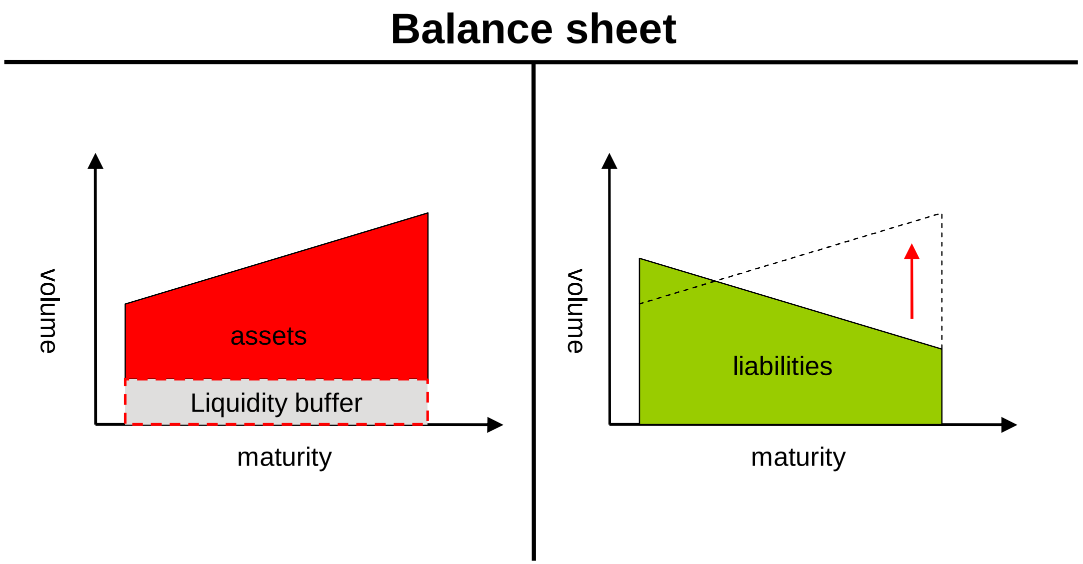
Frankfurt/Main
September 2011

DZ BANK

Table of Content

BASEL III Liquidity Requirements

Requirements due to LCR and NSFR



➔ Quantified liquidity buffer of at least 25 % of liabilities < 30 days

➔ Restriction of structural liquidity mismatches

New regulations presumably have significant implications for the broader banking market

EXAMPLES

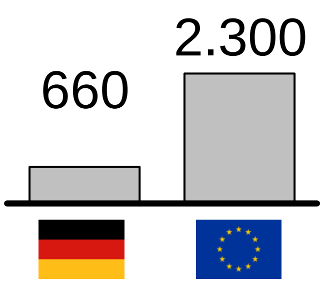
Need for banks to take action due to Basel III regulation*

Liquidity requirement

Bank view, in EUR bn

Need for stable refinancing

Bank view EUR bn



Implications in the broader banking market

High yield requirements for bank bonds

Ø coupons at issuance [1]

– Already far higher yield requirements with respect to other senior unsecured bank bonds
– Rising liquidity requirement implies higher yield requirements – including for DZ BANK
– Due to high wholesale costs prices are also rising with respect to retail deposits

Keener competition for deposits

Santander

4% on deposits

4.5% on 12-month money

1 5-year euro-area banks fair market curves, Bloomberg, 12.4.2011, * data source by McKinsey

International examples already show far-reaching measures in competition for retail deposits

Area	Description	Examples		Main impact
Product	– Introduction of **innovative product features**	Banesto	No interest is paid but customers can get car or bicycle	Volume
	– **Pooling** of various products as supplement to the savings account	Volkswagen Bank direct	Savings counted towards paying down mortgages	Stability
Customer	– Deep analysis of **customer behaviour and needs**; targeted customer pitch	UniCredit Banca	Products tailored for different professions (e.g. free lancers, doctors)	Volume
	– **Customer pitch** acc. to life phase	The Royal Bank of Scotland	Packages offered for different life phases	Stability
Price	– Dynamic pricing with **attractive rates** for limited period or with special conditions	PKO BANK POLSKI	6-month bonus interest rates for new customers	Volume
	– **Variable prices** to maximize revenue and limit churn rate	Millennium bank	Unbeatable interest rates for last month of the term (up to 10%)	Stability

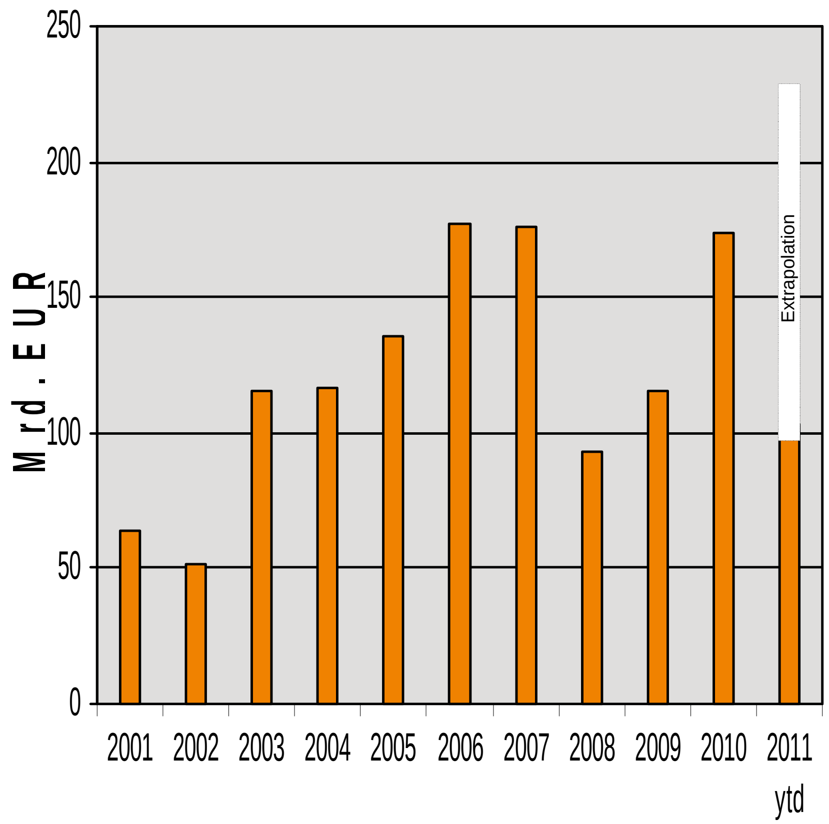
The direction of the action German banks need to take is dictated by regulatory requirements

LBBW
Deutsche Bank
DekaBank
Bayern LB
HypoVereinsbank UniCredit Group
COMMERZBANK

Liquidity Coverage Ratio	– Increased **investment in government bonds** and high-grade **Pfandbriefe/corporate bonds** – Secure the **classification** of corporate deposits **for operating purposes** (25% outflow instead of 75%) – Secure a **differentiation** between stable and less stable **retail deposits** (5% outflow instead of 10%) – e.g. By improved data bases
Net Stable Funding Ratio	– Increased **canvassing for retail deposits** – e.g. by way of cross-selling or special offers – Ensure the **classification** of **retail deposits** as stable (90% eligibility instead of 80%) – **Exit plans for non-strategic assets**

Impact on refinancing

Issuance volumes in the covered bond market



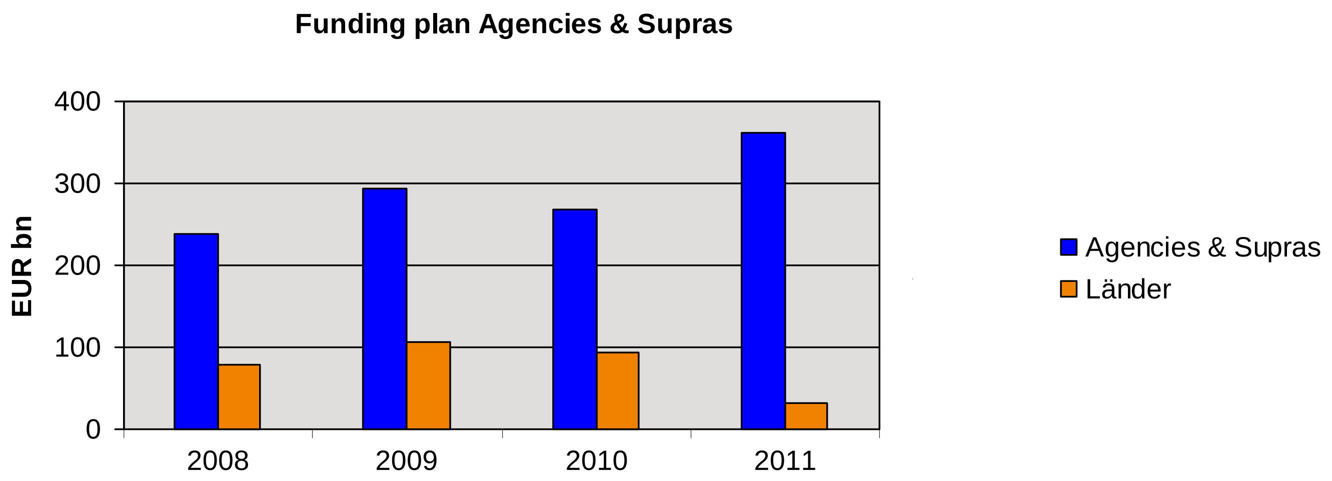
– Customer deposits

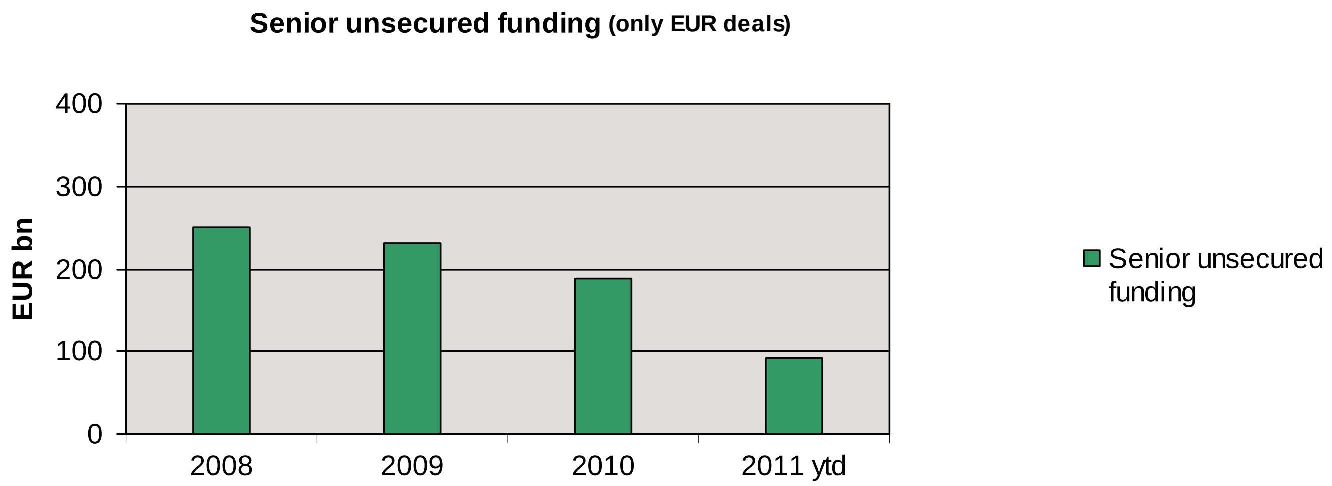
- Most important and stable funding source
- Increased competition
- Price pressure

– Further measures due to new liquidity ratios

- Assets partly outsourced into SPVs/funds
- Increased collateralised funding
- Expansion of long-term funding from institutional investors
- Review of non-core activities under Basel III liquidity/capital costs

Impact on refinancing





3. Impact on the bank's assets side
General statements:

- Limitations for banks without adequate funding sources
- Dearer liabilities-side due to tougher competition and lengthening of the funding's duration is transmitted to pricing in the lending business
- A homogeneous market trend is not to be expected
- Signs of partly strategic, partly operating implementation
- Transfer pricing – option price components in lending operations
- Credit and liquidity lines
- Restructuring of banks' liquidity reserve
  → From profit to cost centre

Medium-term consequences
General statements

- Greater importance of retail customer deposits
- Lengthening of the duration of banks’ liabilities side
- Growing market for collateralised capital market products
- Increased demand for assets eligible for Level 1 and Level 2
- Tendency to pass on funding costs more on the asset side
- Tendency towards diminished intermediary function for banks
- Liquidity balancing function of the money and capital markets between banks is permanently limited
- Credit spreads of senior unsecured bank bonds remain high
- Liquidity spreads will also tend to remain significantly higher after the crisis
- Regulatory liquidity requirements tend to lead towards increased consolidation pressure at the banks

Table of Content

Current situation and challenges

- **Liquidity** proved to be a **critical factor during the financial crisis:** the combination of inadequate liquidity-risk management and the drying up of external sources led to **liquidity bottlenecks** at many banks. In order to avoid this in the future, the regulators reacted by **introducing liquidity ratios**.

- The **cooperative financial network is organised together with its** c**entral institutions** DZ BANK and WGZ BANK **as a liquidity pool**. The central institutions act as a central **"liquidity market place":** Surplus liquidity at individual banks is pooled in the central institution and immediately made available as the need arises.

- **CRD IV now lends the liquidity balancing function** within the financial network – which was still too little heeded in Basel III – better **possibilities for inclusion** in determining liquidity ratios. First, due to the so-called **central institution privilege** and, second, to the **option of a group waiver** – in other words the collation and reporting of ratios for the cooperative financial network as a whole.

Current activities:

- **DZ BANK** has set up its own **Liquidity Task Force** to examine current challenges and possible options for action. This task Force coordinates **closely** with the Capital Expert Committee and the internal "Regulatory Developments" working group. In addition, **there is a close relationsship carried out under the leadership of the BVR** In the interests of the cooperative financial network with regard to issues such as liquidity, capital and large loans (leverage ratio).

For 125 years the core task for the central institution: ensure liquidity balancing in the financial network

DZ BANK's role as a liquidity and risk manager:

- Accept unlimited deposits from the cooperative banks at all times
- Short- and long-term refinancing for the cooperative banks
- Internal financing of the DZ BANK Group
- Risk taker of counterparty and market price risks for the cooperative banking group
- Clearing of liquidity risk positions
  - short term liquidity risks
  - Match maturities

DZ BANK's liquidity balancing function greatly impaired by Basel III

DZ BANK's role

Liquidity balancing function in the cooperative financial network as a **core task of the central institution** for over 900 cooperative banks

- The cooperative banks' deposits are accepted at all times
- Assumption of liquidity risks

➔ No liquidity problems during the financial crisis

Liquidity clearing function

Risk caused by new regulation and the tougher market environment it creates

Stricter regulation

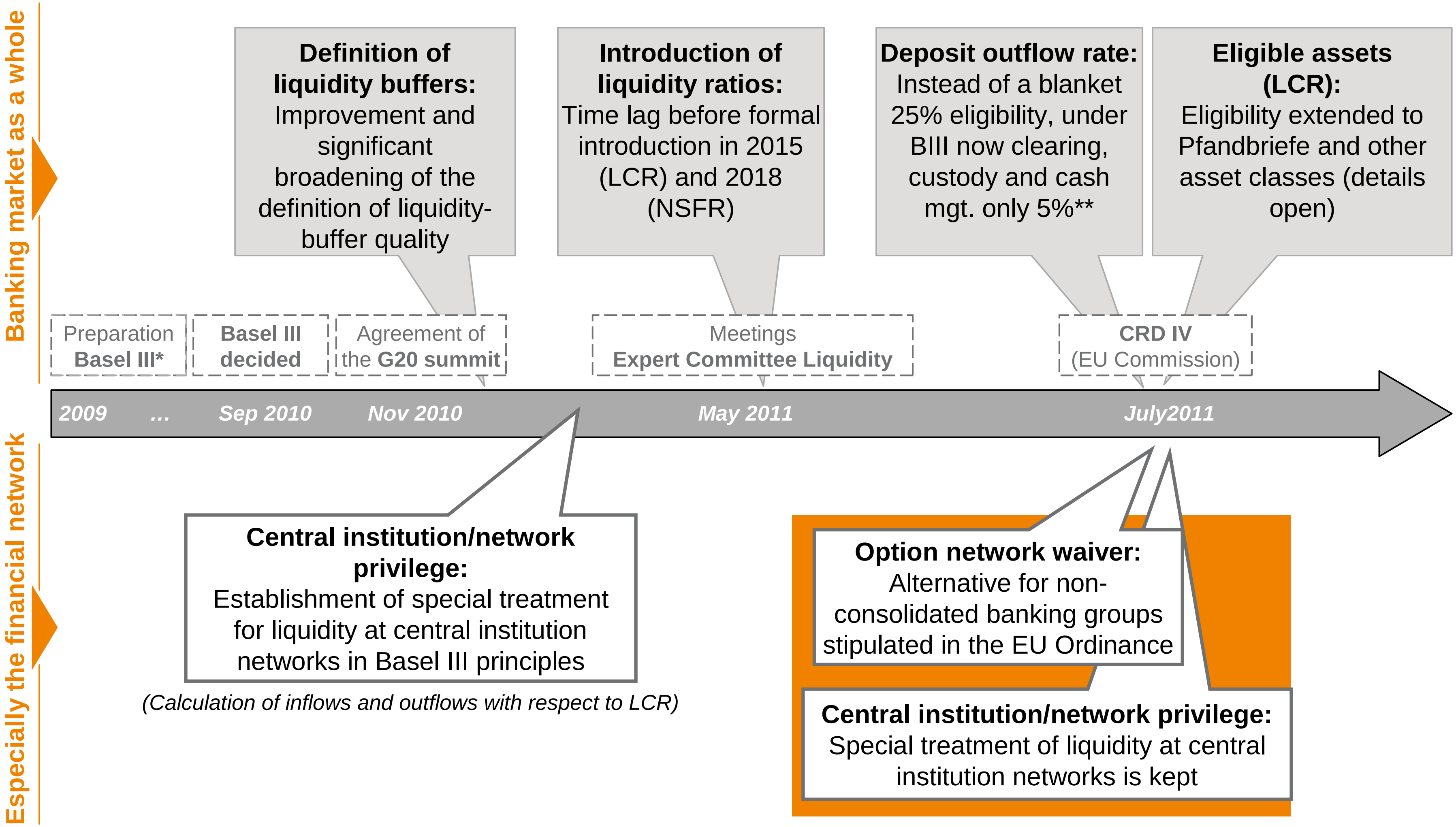
- New ratios under Basel III (LCR / NSFR) place heavier requirements on future liquidity management and refinancing
- Insufficient account taken of interdependences within the financial network as ratios have to be reported at the individual bank level

Market environment

- Liquidity costs have been far higher since the crisis
- Increasing competition for structural liquidity

New regulations will influence the intermesh between central institutions and cooperative banks as a single unit – and thus one of DZ BANK's core functions

Improvements have already been obtained – approach within the financial network is still open



* In particular Basel Consultation Papier CD 165 (17.12.2009)
** Applies to deposits of banks belonging to a network at their central institutions / specialised service providers

Multi-layered implications for the cooperative financial network due to market and regulatory changes

Sparda-Bank

Market and regulatory changes

- Keener competition for retail deposits drives refinancing costs
- Local cooperative banks expect higher liquidity prices for short-term deposits (sustainability)
- Higher prices for unsecured bank bonds due to lack of eligibility for the liquidity buffer
- Upgrade of liquidity buffer portfolios to Level 1 and Level 2 assets

DZ BANK

Control measures