

EPFSF Lunch “CRD: Understanding the changes - and why?”

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Mr Purvis, Mr Ravoet,

Members of the European Parliament,

Ladies and Gentlemen,

The topic of today’s lunch debate could not be more timely. Just last week, the Commission released its proposal for a revision of the Capital Requirements Directive and submitted it to the European Parliament: it is now in your hands — working together with the member states — to find the best way to move forward with the regulatory framework for capital requirements. I appreciate the opportunity to be able to provide you with some thoughts and concerns from a financial industry perspective. I would like to focus in particular on two aspects of the proposal:

1. Hybrid Capital Instruments and
2. Large Exposures, in particular regarding banking counterparties.

With regard to the first point (Hybrid Capital Instruments): we welcome the fact that the Commission has taken a largely principles-based approach in its proposals for recognising hybrid instruments as Tier 1 capital. Given the differences in company law, tax regimes and insolvency rules across jurisdictions, only a principles-based

approach can enable member states to implement the directive in a way which is economically consistent. This will create legal certainty for institutions and safeguard a level playing field across Europe regarding the definition of own funds. And as the proposals are strongly based on the Basel Committee's 1998 guidelines, there will be no distortion of competition in the global arena. While the banking industry still sees a need to address a number of smaller technical issues, we are very pleased with the path the Commission has chosen to go regarding these instruments.

However, on the second aspect — Large Exposures — some industry concerns have not yet been fully considered.

The current Commission proposal regarding Large Exposures states that all interbank exposures shall be limited to 25% of own funds regardless of their maturity structure. Motivation for this change appears to be the simple idea that risk events can happen at any point in time and that a bank can naturally therefore default at any time as well. Accordingly, the new limitation on interbank exposures is intended to reduce spill-over effects within the banking industry.

We as Commerzbank — and I believe I speak for the German and European banking industry in general — take a rather critical view of this undifferentiated approach. We fear that the proposed limitation will in fact have a crisis-intensifying effect rather than serving — as intended — as a preventative measure. This is the case because the current proposal would apply to *all* liquidity-securing measures — long-term measures as well as short-term ones.

The fundamental case for change is clear: the developments of the last year have shown that risks can and do develop in markets other than money markets — we have seen, for instance, the risks related to SPVs — only to spill over to the money markets and here to begin to unfold their full potential. While the current crisis was ultimately resolved through concerted intervention by central banks, many institutions were nevertheless able to master the tightening market conditions without the need for significant external support. But limiting short-term interbank exposures or repo transactions, as currently proposed, would reduce the number of potential business partners significantly and prevent banks from helping themselves, thus forcing troubled banks to become even more dependent on the active management (and intervention) of central banks.

It is also worth making a pragmatic point regarding the limitation of large exposures in this context. For operational reasons, institutions' internal limits on money market transactions will in general be lower than the regulatory limit. Due to the large number of transactions and business partners, it is simply not possible to manage large exposures up to the limit on the daily basis. For this reason, banks will always have a built-in cushion rooted in their internal limit systems.

However, the proposed limitations would most directly impact money market products, which can be traded easily, cheaply and at short notice, rather than hitting, for instance, derivatives or securities. Thus, under the implementation of a large exposure limit without any exemptions, the impact on money market products would be disproportionately severe.

To reduce the spill-over risk without the risk of hindering money market transactions as just described, we would offer an alternative solution. We would propose to exclude transactions with maturities of up to three months from the 25% limit on Large Exposures. With such an exclusion, spill-over risks would be actively limited, while short-term liquidity management would not be affected.

This alternative proposal has several positive effects:

1) It would still maintain the strong limitation desired by regulators and would therefore serve to reduce risk, since derivatives, issuer and off-balance-sheet risk as well as credit exposures with remaining maturities of more than three months would still be included in the limit. Currently, all exposures with remaining maturities of up to one year are excluded from the Large Exposure limits.

2) In critical situations, it would be possible for liquidity-securing transactions to be conducted quickly without the barrier of supervisory restrictions.

3) Our proposal is structurally consistent with the current regulatory framework, since it takes remaining maturities into account. This new proposal would therefore serve to facilitate implementation across the banking industry.

Last but not least, I would like to welcome the fact that the final Commission proposal has taken into account industry concerns regarding an exemption for smaller banks by excluding amounts of up to 150m € from the Large Exposure limits. These amounts do not cause systemic risk. Absence of such an exemption would have led

to a clear discrimination against smaller banks. The German Bundesbank found that, in Germany, approximately 380 small banks would have had to change their current business practices. Smaller banks frequently provide loans to a few larger banks with good creditworthiness, drawing on other regional banks for their refinancing. Forcing these banks to broaden their refinancing and lending bases could have provided these banks with negative incentives to do business with banks of poorer credit quality. It would also have led to higher operational costs and to the adoption of more complex risk profiles for these banks. The final Commission proposal now deals with these issues in a sensible way.

I look forward to a frank and interesting discussion with you. I thank you very much for your attention.