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Liquidity management and asset disposal strategies in Covered bond issuer’s stress scenarios

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Examples of failed covered bond banks

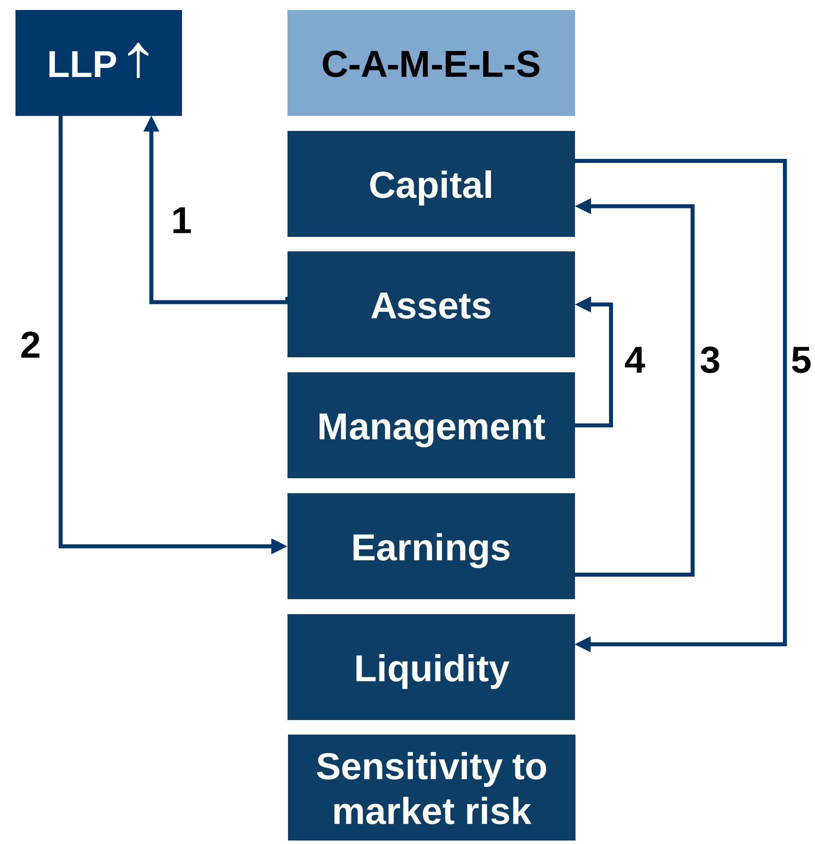
Year	Country	Name	Resolution
25-Oct-05	GER	Allgemeine Hypothekenbank Rheinboden AG	▪ Deposit insurance fund accompanies transfer to a new owner. ▪ Consortium of five German banks provides liquidity support. ▪ Orderly wind down of non-strategic businesses.
20-Sep-07	UK	Northern Rock	▪ Public ownership, capital injection & guarantee commitments ▪ Transfer of deposits, unencumbered mortgages and the business platform to a new legal entity. ▪ Retention of the cover pool as well as non-strategic / non-performing assets and covered bonds as well as a government loan and derivatives in the existing company with the aim of winding it down.
21-Apr-08	GER	Düsseldorfer Hypothekenbank	▪ Transfer to the deposit insurance fund and later sale to a new owner. ▪ Liquidity support and guarantees provided by the deposit insurance fund and a bank consortium.
25-Sep-08	US	Washington Mutual	▪ FDIC receivership ▪ Transfer of deposits, certain assets, the business platform as well as covered bonds and attached cover pool assets to another US bank (JP Morgan Chase).
1-Oct-08	UK	Bradford & Bingley	▪ Public ownership, capital injection & guarantee commitments ▪ Transfer of deposits and the business platform to another UK bank (Abbey National). ▪ Retention of the cover pool as well as non-strategic / non-performing assets and covered bonds as well as support instruments and derivatives in the existing company with the aim of winding it down.
2-Oct-08	GER / IRE	Hypo Real Estate / Depfa ACS Bank	▪ Transfer to SoFFin, the German financial market stabilisation fund. ▪ Liquidity support and guarantees provided by a consortium of German banks and Deutsche Bundesbank. ▪ Transfer of non-strategic / non-performing assets to a liquidation entity.
3-Nov-08	AUT	Kommunalkredit Austria	▪ Public ownership, capital injection & guarantee commitments. ▪ Transfer of strategic assets including the cover pool and related covered bonds to a new legal entity. ▪ Retention of non-strategic assets as well as government-guaranteed bonds and the troubled asset guarantee in the existing company with the aim of winding it down.

Generic example for risk transmission

Loan loss provisions (LLP) & the risk profile of banks

Code	Transmission	Warning signals
1	Asset to LLP	Deteriorating asset quality leads to increasing LLP
2	LLP to earnings	More LLP erode earnings
3	Earnings to capital	Net losses erode capital
4	Management to Assets	Measures by management to preserve asset quality
5	Capital to liquidity	Liquidity mechanisms in place to support solvency

CAMELS scheme*



*Note: *The acronym "CAMELS" stands for Capital, Assets, Management, Earnings, Liquidity and Sensitivity to market risk, six components of a bank's financial operation. It is based on the US Federal Financial Institutions Examination Council's (FFIEC) Uniform Financial Institutions Rating System (UFIRS) which was developed to assess risk on a system wide basis. CAMELS ratings are assigned on a scale of 1 to 5 with 1 being the highest and 5 the lowest.*

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Covered bond stress scenarios

- **Maintain and/or (re-)establish the funding framework**
  - What are the funding options in a stressed environment?
  - What strategies can be developed to maintain or broaden funding options?
  - What strategies can be applied to ease refinancing stress?
- **Preserve asset value through alignment of interest**
  - How well aligned are the investor's and the administrator's interest?
  - What legal or contractual features are in place to ensure a proper alignment of interest?
- **Minimize gap between market value and intrinsic value**
  - What drives the decision making between outright sale (=less risk, lower proceeds, market value) or retention of assets (=more risk, higher proceeds, intrinsic value)?
  - How could the use of loss sharing agreements or structured sales help reduce the gap between market value and intrinsic value?

Asset Management Options

	Outright Sale	Structured Sale	Retention
Benefits	▪ Dispose of all risk ▪ Monetize proceeds ▪ Reduce operational complexities / need for ongoing monitoring	▪ Incremental cash proceeds ▪ Enhanced market capacity through marketability of both debt and equity ▪ Straight-forward transaction structure in most markets	▪ Retain all upside ▪ Proper alignment of interest can result in superior performance
Drawbacks	▪ Loans may trade at significant discount to intrinsic value ▪ No upside retention ▪ Potential representations and warranties ▪ Less market capacity due to capital required	▪ Cost of unrated debt may be more expensive than entity's cost-of-funds ▪ If debt retained, then significantly less proceeds ▪ New documentation ▪ Losses taken upfront	▪ Retain all risk ▪ No proceeds

Learning from the FDIC?

- As the receiver for failing and failed institution, the FDIC has developed numerous structures in order to dispose of assets and liabilities through sales to banks and other capital markets transactions.
- The FDIC continues to add and modify structures for its resolution process to facilitate sales, to minimize cost to the Deposit Insurance Fund and to achieve best execution.
- FDIC-assisted acquisitions feature a shared loss agreement. It is constructed to share losses between the FDIC and the Assuming Bank in order to limit the loss risk, volatility of the return profile, required due diligence and capital for the assuming bank, while maximizing value for the FDIC.
- The FDIC has established the infrastructure to dispose of assets through structured sale transactions, which allow the FDIC to minimize the difference between intrinsic value and market value by selling a significant portion of the equity interest in the assets to a servicer/asset manager.
- To maximize the value of assets, the FDIC has started providing FDIC-guaranteed leverage in structured sales transactions through issuance of Structured Sale Guaranteed Notes (SSGN).

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