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Plenary Lecture

Heinz Hilgert
Member of the Board, DZ BANK

Transfer of Corporate Credit Risk within the Cooperative Bank Network
Transfer of corporate Credit Risks within the Cooperative Bank Network

Heinz Hilgert, Member of the Board of Directors,
DZ BANK Deutsche Zentral-Genossenschaftsbank AG
The Idea behind

- German Cooperative banks have an excellent knowledge and understanding of their credit clients due to their decentralized structure.

- The cooperative banks’ individual credit portfolio is relatively small as a result of their strictly separated geographical responsibility.

- But for an effective portfolio diversification, a large portfolio is preferably advantageous.

- **The task:** DZ BANK as the central bank for the cooperative sector has the function to transfer the risk from the cooperative banks
  - in the form of syndicated loans
  - new: in the form of new security products (ABS Asset Backed Securities)

- **The result:** Local cooperative banks are now in a position to manage their credit risks actively! DZ BANK changes from risk taker to risk trader.
Successful ABS transactions in the cooperative network

- **Promise-Z 2001-1**
- **CLN BAG Hamm (2002+2003)**
- **VR Circle (2005-1 / -2)**

**ABS**
- Credit Card claims
- Consumer loans
- Lease claims
- Future payments

**Asset Backed Securities (ABS)**
- **Debt (CDO)**
- Loans (CLO)
- Bonds (CBO)

**Mortgage loans (MBS)**
- Residual mortgage loans (RMBS)
- Commercial mortgage loans (CMBS)

- Provide-VR (2002,03,04)

**GELT (2002)**
- League (2003,04,05)

**KONSUS 2004**

**DYNASO I-III (2002,04,05)**

**Proscore-VR 2005-1**
Example 1: VR Circle
Basic Structure of the *VR Circle* as a cycle model

**Protection Buyer**

- Bank 1
- Bank 2
- Bank 3
- ...
- Bank n

**Risk Transfer per Bank-CLN**

**Special Purpose Vehicle** „VR Circle Ltd.“, Jersey (SPV)

- Bank-CLNs 1 to n
- SPV-CLN

**Risk Transfer per SPV-CLN**

**Protection Seller**

- Bank 1
- Bank 2
- Bank 3
- ...
- Bank n

**Balance Sheet of the Cooperative Bank**

<table>
<thead>
<tr>
<th>Loans</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>Funding</td>
</tr>
<tr>
<td>(incl. SPV CLN)</td>
<td>(of loans and Bank-CLN)</td>
</tr>
</tbody>
</table>
**General Conditions of the VR Circle deals (extract)**

- **Loan Type:** Loans, Back-up lines, Guarantees

- **Reference Value of the protection:** max. 50% of the total (senior unsecured) nominal credit exposure

- **Purposes:** General Corporate purposes (Commercial & Industrial) independent of the collateralization

- **Credit Quality of the corporate loan:** Minimum of 2D, acc. to BVR II-Rating \( (PD = \text{max. } 1.70\% \text{ p.a.}) \)

- **Maturity:** max. 10 years

- **(Credit) Events of Default:**
  a. the county court’s decision to refuse or open a bankruptcy case or
  b. 90 days delay of payment of more than 10,000 Euro plus cancellation and initiation of common sanctions to terminate the business relationship

- **Interface with the borrower:** The whole credit process remains within in the cooperative bank.
**VR Circle: Added value for the participating Banks**

- **Short-term preparation & execution, active credit risk management with manageable effort**
  
  - Diversification of the credit risk in terms of size, industry sector and/or region  
    = Reduction of concentration risk
  
  - Reduction of Value Adjustment-Volatility (P&L)
  
  - Reduction of the unexpected loss probability (VaR) by up to 15%  
    (free economic capital)
  
  - Minimal P&L effect: despite the protection costs of the Bank-CLN,  
    the cooperative bank will receive earnings from the SPV-CLN
  
  - Prevention of a potential bank default (less usage of BVR-SE)
  
  - Progress on the learning curve for future (capital market) transactions
  
  - Cost-advantages due to sector-internal solution; avoiding extreme costs  
    of external rating agencies
Monte Carlo-Simulation without VR Circle

Monte Carlo-Simulation with VR Circle

On the basis of equal expectations for value adjustments (€ 4 m.), extreme scenarios are reduced significantly which smoothes the profit and loss account, which is then easier to calculate.
Reduction of the unexpected loss probability (VaR)

Before: blue
After: orange

Frequency distribution of credit losses

$EL_1 = EL_0$

$99\%-\text{Quantile}_1 << 99\%-\text{Quantile}_0$
Example of a participating Bank of VR Circle 2005-1

5 loans out
75 loans in
volume constant
VaR – 6,2%
Minimal P&L effect  (figures of VR Circle 2005-1)

Balance Sheet of the Cooperative Bank

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<th>Loans</th>
<th>Securities (SPV-CLN)</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Funding (of loans and Bank-CLN)</td>
<td></td>
</tr>
</tbody>
</table>

Interest earnings of loans: unchanged

- Interest exepnse of funding: unchanged

- Interest exepnse of KG-CLN: 0.47% to 1.42% Credit Spread

+ Interest earnings of SPV-CLN: 0.79% Credit Spread minus 0.27% fees
Further reasons for taking part in VR Circle

- No interference in the client relationship (synthetic transaction)
- Pooling conditions reflect requirements of the cooperative banks and market practice
- Economies of scale: individual costs decrease with increasing transaction volume
- Reporting and accounting have been coordinated with all auditing associations
- Technical feasibility in electronic data processing centres approved
- The transaction structure is backed by the respective regulatory authorities, which include BaFin (Federal Financial Supervisory Authority), Bundesbank (German Central Bank) and auditors
Example 2: Proscore-VR 2005-1
## Overview VR Circle vs. Proscore-VR 2005-1

<table>
<thead>
<tr>
<th></th>
<th>VR Circle</th>
<th>Proscore-VR</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Originator</strong></td>
<td>100% cooperative banks</td>
<td>6,2% cooperative banks 93,8% DG HYP</td>
</tr>
<tr>
<td><strong>Vehicle of risk transfer</strong></td>
<td>CLN = synthetic transaction</td>
<td>CDS = synthetic transaction</td>
</tr>
<tr>
<td><strong>Reference value of the protection</strong></td>
<td>A free defined part of the uncovered credit (net of collateral)</td>
<td>Nominal loan amount</td>
</tr>
<tr>
<td><strong>Investor base</strong></td>
<td>Closed (cooperative banks)</td>
<td>Open (institutional investors)</td>
</tr>
<tr>
<td><strong>Influence on the risk position of the originator</strong></td>
<td>Risk reduction and risk investment</td>
<td>Risk reduction</td>
</tr>
<tr>
<td><strong>Capital consumption</strong></td>
<td>Unchanged</td>
<td>Reduced</td>
</tr>
<tr>
<td><strong>Investors</strong></td>
<td>Participants of the transaction (cooperative banks)</td>
<td>Capital market</td>
</tr>
<tr>
<td><strong>Cost elements</strong></td>
<td>Acquisition, Structuring</td>
<td>Acquisition, Structuring, Rating, Sales</td>
</tr>
</tbody>
</table>
Key Issues

- Fourth Multiseller-Transaction within the German cooperative banking sector
- Development of the successful multiseller RMBS transaction Provide-VR, now extending to commercial real estate risk
- First Multiseller-Transaction securitising German small commercial mortgage loans
- Originators:
  - DG HYP: 93.8 % of the initial total pool volume of Euro 735m
  - 6 cooperative banks: 6.2 % of the initial total pool volume
Benefits for the participating cooperative banks

- **Regulatory benefits:**
  - Release of regulatory capital (with regard to the outplaced senior tranches)
  - Release of the large exposure limit (according to § 13 KWG)

- **Economic benefits:**
  - Outplacement of the unexpected loss probability
  - Reduction of the maximum loss risk
  - Cap of individual loss provisions and write-offs in the future
  - Reduction of mandatory contributions to the Guarantee Fund of the BVR-SE

- **Strategic benefits:**
  - Positive appearance towards the auditors and regulatory authorities through use of modern risk management instruments
  - Increasing awareness of management and employees for active credit risk and equity management
Transaction Structure Proscore-VR 2005-1

DZ BANK Arranger and Lead Manager

Reference Portfolio

DG HYP

Bank Swap

Senior Swap Counterparty

KfW

Super Senior Swap

PROSCORE-VR 2005-1 PLC (SPV)

Certificates (CLS)

Credit Linked Notes

INVESTORS

Sub-Pool CDS = Sub-Pool Credit Default Swap

SPV = Special Purpose Vehicle

CLS = Credit Linked Schuldscheine

KG = Cooperative Bank

Sub-Pool Outstanding Threshold Amounts

DG HYP Reference Pool

All KG-Reference Pools

KG Reference Pool

Cooperative Bank („KG“)
Example 3: LEAGUE 2005-1
Motivation

- The corporates‘ demand for the balance sheet management tool leasing has led to a strongly growing yet highly price sensitive and competitive market.

- Leasing as an off-balance sheet financing alternative to the traditional financing through bank loans extends the cooperative banks‘ product range for corporate clients.

- Investing in the securitisation transaction, the cooperative banks nevertheless have the opportunity to take leasing risk exposure without increasing their exposure to DZ BANK Group.

- Securitising its lease receivables, the primary goal for VR-LEASING AG is to improve its refinancing conditions. Such improvement is achieved by:
  - cheaper funding for VR-LEASING AG: ./. 0,23 % p.a. (average investor margin vs. traditional refinancing)
  - diversifying its funding base,
  - reducing its dependance from the classical funding sources.

- Another goal of the securitisation is the regulatory capital relief on the level of DZ BANK Group (approx. 6%).
Credit Risk vs. Market Risk

- In LEAGUE 2005-1, the credit risk of the lessees (Series 1) as well as the market risk of the residual values of used cars (Series 2) is securitised within one structure but in two separated series. ➔ Chance for the investors to diversify.

- Series 1 (EUR 374m) represents the credit risk of the lessees, that is the redemption of the series 1 notes depends exclusively on the payments made by the lessees (ongoing lease instalments and guaranteed residual values).

- Series 2 (EUR 50m) represents the market risk, that is the redemption of the series 2 notes depends exclusively on the realised residual values of used cars not guaranteed by the lessees (open residual values).

- The redemption and the interest payment of one series does not affect the redemption and the interest payment of the other series.
Investor Benefits

➡️ Asset Diversification:
- Only 13% of the new issuance in 2005 (by volume) within the structured credit market was issued as ABS.
- Thus, the ABS transaction LEAGUE 2005-1 is an attractive investment to diversify a portfolio.
- Furthermore, LEAGUE 2005-1 also enables the investor to take different types of risk exposure: credit risk of the lessees or market risk of used cars.

➡️ Pricing:
- Compared to investments with the same credit ratings, LEAGUE 2005-1 offers an attractive yield pick-up.
- In Series 2, open residual values were securitised for the first time in any European ABS transaction. Thus, investors benefit from a first deal premium.

➡️ Performance:
- GELT 2002-1: Upgrades of all tranches since closing.
- LEAGUE 2004-1: Performance above expectations.
Basic Structure LEAGUE 2005-1

5th securitisation of lease receivables of the cooperative banking sector