

3.11 GERMANY

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I. FRAMEWORK

In Germany, the legal basis for Covered Bond issuance is the German Pfandbrief Act (PfandBG – Pfandbriefgesetz) dated 22nd of May 2005. It supersedes the general bankruptcy regulation (§§ 30-36 of the Pfandbrief Act).

In addition and for historic reasons, three further legal frameworks are existing in German law for the issue of Covered Bonds (DZ-Bank Covered Bonds, DSL Covered Bonds and Landwirtschaftliche Rentenbank Covered Bonds). The range of cover assets is slightly different compared to Pfandbriefe (they may include for instance a much higher portion of claims against credit institutions), but their insolvency regime is rather similar to the Pfandbrief rules. For more details, see 'Das Pfandbriefgesetz', Textsammlung und Materialien, edited by the Association of German Pfandbriefbanks, Frankfurt a.M. 2005, page 277-280.

On 26 March 2009 amendments of the PfandBG came in force introducing a new Pfandbrief category, the Aircraft Pfandbrief, and furthermore enhancing the attractiveness of Pfandbriefe for investors. Among many improvements, a further liquidity safeguard has been implemented by introducing a special liquidity buffer of 180 days. Since spring 2010, further amendments have been discussed in Parliament in order to strengthen the position of the special cover pool administrator; they came in force on 25 November 2010 and on 1 January 2011.

II. STRUCTURE OF THE ISSUER

Since 2005, the issuer of Pfandbriefe is no longer required to be a specialised bank. Instead, Pfandbrief issuers are allowed to exercise all activities of a credit institution, although a special licence for Pfandbrief issuance is required. The minimum requirements to obtain and keep the special licence are as follows:

- > core capital of at least 25 million euros
- > general banking licence which allows the issuer to carry out lending activities
- > suitable risk management procedures and instruments
- > business plan showing regular and sustainable issues as well as necessary organisational structure

Since the German outsourcing guidelines of the BaFin do not allow for the outsourcing of important and decision-making sections of the credit institution, the issuer is required to have its own employees. In addition, the PfandBG requires Pfandbrief banks to manage their own risk and take their own credit decisions on their own.

The issuer holds the cover assets on his balance sheet. A subsequent transfer of the cover assets to another legal entity does not take place. Given that a direct legal link between single cover assets and Pfandbriefe does not exist, all obligations relating to Pfandbriefe are obligations of the issuing bank as a whole, to be paid from all the cover assets of the issuer, recorded in the cover register. In the case of insolvency, the cover pool is segregated by law from the general insolvency estate and is reserved for the claims of the Pfandbrief holders. Even then, Pfandbrief holders still have a claim against the general insolvency estate.

III. COVER ASSETS

Cover assets are produced by mortgage lending, public sector lending, ship and aircraft financing activities. ABS/MBS are not eligible. A specific class of Covered Bonds corresponds to each of these cover asset classes: Hypothekendarlehenbriefe, Öffentliche Darlehenbriefe, Schiffsdarlehenbriefe and Flugzeugdarlehenbriefe. The respective Darlehenbrief must be fully secured by its specific cover asset class (§ 4 PfandBG). Detailed transparency requirements are regulated in § 28 PfandBG, enhanced by the amendments 2009 and 2010.

Up to 10% of the nominal volume of Darlehenbriefe outstanding may consist of money claims against the European Central Bank, central banks in the European Union or against suitable credit institutions, which fulfil the requirements of credit quality step 1 according to Table 1 of the Annex VI of Directive 2006/48/EC.

The geographical scope of eligible mortgage assets is restricted to EU/EEA countries, to Switzerland, USA, Canada and Japan. Public sector loans to these countries are eligible for the cover of Öffentliche Darlehenbriefe (§ 20 PfandBG). The total volume of loans granted in non-EU countries where it is not certain that the preferential right of the Darlehenbrief creditors extends to the cover assets, may not exceed 10 % of the total volume of the cover loans (§§ 13 I 2, 20 I 2 PfandBG) and 20 % for ship and aircraft mortgages (§§ 22 V 2, 26b IV PfandBG).

Derivatives are eligible for cover pools under certain conditions. They must not exceed 12% of the cover assets when calculated on a net present value basis (§ 19 I 4. PfandBG).

Transparency of cover assets:

§ 28 PfandBG requires issuers to publish detailed data on the composition of cover pools. These include

- > the total volume of Darlehenbrief outstanding as well as the related cover pools in terms of nominal, net present and stressed net present value;
- > the share of derivative financial instruments in the cover assets;
- > the share of further cover assets;
- > the maturity structure of the Darlehenbrief and cover assets;
- > Information on the granularity of the cover assets;
- > Information on the mortgages by property type/type of use, region and state;
- > Information on the claims against the public sector by state and type of issuer;
- > Information on the ship mortgages/aircraft registered liens by register country; and
- > Information on non-performing cover assets;

Within the scope of the vdp Transparency Initiative the transparency reports of vdp member institutions are published in a uniform format¹.

¹ http://www.pfandbrief.de/cms/_internet.nsf/tindex/en_pub_pfandbg.htm

IV. VALUATION AND LTV CRITERIA

Property valuation is regulated in § 16 PfandBG. This provision refers to the mortgage lending value (Beleihungswert) which is, in contrast to the market value, based on sustainable aspects of the property. Details about the valuation process and the qualifications of valuers are regulated in a specific statutory order on the mortgage lending value (Beleihungswertermittlungsverordnung, BelWertV), § 16 IV PfandBG.

Monitoring requirements result from the Capital Requirements Directive (once a year for commercial real estate and once every three years for residential real estate). In addition, § 27 BelWertV requires a review of the underlying assumptions when the market has declined substantially; a review of property values is also necessary when the loan has defaulted.

The BelWertV requires personal and organisational independence of the valuer (internal or external valuer)

For both commercial and residential property, the LTV limit is 60 % of the mortgage lending value of the property. This LTV is a relative limit, i.e. when the loan exceeds the 60% limit, the part of the loan up to 60% LTV remains eligible for the cover pool.

V. ASSET - LIABILITY MANAGEMENT

§ 4 PfandBG stipulates that the total volume of Pfandbriefe outstanding must be covered at all times by assets of at least the same amount. Thus, the nominal value of the cover assets must permanently be higher than the respective total value of the Pfandbriefe.

In addition, the Pfandbrief Act requires that Pfandbriefe are covered on a net present value basis even in the event of severe interest rate changes or currency fluctuations. The issuer has to provide an overcollateralisation of at least 2% after stress tests which have to be carried out weekly. Both the maturity of outstanding Pfandbriefe and the fixed-interest periods of the cover pool are disclosed on a quarterly basis. Details about the calculation are regulated in a special statutory order Net Present Value (Barwertverordnung).

Furthermore, each day Pfandbriefbanks have to calculate the maximum liquidity need within the next 180 days. This amount has to be covered by liquid assets (§ 4 Ia PfandBG).

Every quarter, the stress-tested NPV of outstanding Pfandbriefe, the cover pool and the overcollateralisation have to be published (§ 28 I PfandBG). The stress tests apply not only to interest rate risks but also to foreign exchange risks.

Cash flow mismatch between cover assets and covered bonds is furthermore reduced by the prepayment rules applicable to fixed interest rate mortgage loans. Prepayments of mortgages during fixed rate periods are only permitted in cases of 'legitimate interest' of the borrower or after a period of ten years. If the mortgage is prepaid, the borrower has to compensate the damage of the lender caused by the prepayment (§ 490 II German Civil Code).

VI. COVER POOL MONITOR AND BANKING SUPERVISION

A cover pool monitor (Treuhand) supervises the cover pool. He is appointed by the BaFin and must possess the expertise and experience necessary to fulfil all duties. A qualification as a certified auditor suggests that the necessary expertise is provided.

The monitor has to ensure that the prescribed cover for the Pfandbriefe exists at all times and that the cover assets are recorded correctly in the cover register, §§ 7, 8 PfandBG. Without his approval, no assets

may be removed from the cover pool. The BaFin has published a specific statutory order on details of the form and the contents of this cover register (Deckungsregisterverordnung – DeckRegV), § 5 III PfandBG.

In addition, BaFin carries out a special supervision on Pfandbrief banks. The former division on mortgage banks (Referat Hypothekenbanken) was transformed into the division “Pfandbriefkompetenzcenter I - Grundsatzfragen”, which is responsible for all fundamental issues regarding the PfandBG. In January 2006, the BaFin set up a special division for cover pool audits (“Pfandbriefkompetenzcenter II – Deckungsprüfungen”).

Furthermore, the BaFin has to monitor the cover pool on average every two years (§ 3 PfandBG) and to this end it may appoint auditors with special knowledge in this area. Finally, BaFin carries out the general banking supervision on German Pfandbrief banks.

VII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

A cover register (Deckungsregister) permits the identification of the cover assets, § 5 PfandBG. The register records the cover assets being used to cover the Pfandbriefe as well as claims under derivatives (§ 5 I 1 PfandBG).

The legal effect of registration is that in the case of insolvency of the issuer, the assets which form part of the cover pool can be identified: All values contained in the register would not be part of the insolvency estate. § 30 I 1 PfandBG now calls them “insolvency-free assets”.

While the bank carries out the daily administration of the cover register, it is the cover pool monitor who supervises the required cover and registration in the cover register, § 8 I, II PfandBG. Copies of the cover register shall be transmitted to the supervisory authority on a regular basis.

Asset segregation

The cover pool is a part of the general estate of the bank as long as the issuer is solvent. If insolvency proceedings are launched, by operation of law, the assets recorded in the cover registers are excluded from the insolvency estate (§ 30 I 1 PfandBG). Those assets will not be affected by the launching of the insolvency proceedings (§ 30 I 2 2. HS PfandBG).

After the launching of the insolvency proceedings, a special cover pool administrator (Sachwalter) carries out the administration of the cover assets (§ 30 II 1 PfandBG). Through the appointment of the cover pool administrator by the court, on proposal of the BaFin, the right to manage and dispose of the recorded assets will be transferred to him automatically by law (§ 30 II 2 PfandBG). Regarding cover assets and timely payment of Pfandbriefe, the cover pool administrator represents the Pfandbriefbank (§ 30 II 5, 6 PfandBG). He is allowed to use premises and staff of the Pfandbriefbank (§31 VIII PfandBG).

The cover pool administrator may even be appointed before the insolvency proceedings have been launched (§ 30 V PfandBG).

Impact of insolvency proceedings on Covered Bonds and derivatives

Covered Bonds do not automatically accelerate when the issuing institution is insolvent, but will be repaid at the time of their contractual maturity. The same applies to derivatives which are registered in the cover register and form part of the cover pool. Accordingly, the German master agreements for cover derivatives stipulate that the bankruptcy of the Pfandbrief issuer does not signify a termination event. Article 13 N° 6 DeckregV stipulates that the collateral provided by the derivative counterpart or

the Pfandbrief bank has to be registered in the cover register. The consequence of such registration is that the collateral belongs to the insolvency-free assets.

Preferential treatment of Covered Bond holders

Covered Bond holders enjoy preferential treatment as the law stipulates the separation of the cover assets on the one hand and the insolvency estate on the other, § 30 I PfandBG.

The satisfaction of the Pfandbrief creditors is not limited to the cover assets. On the contrary, these creditors also participate in the insolvency proceedings with respect to the Pfandbrief bank's remaining assets.

Only in the case of over-indebtedness or insolvency of the cover assets, the BaFin may apply for a special insolvency procedure relating to the cover pool and Covered Bonds (§ 30 VI PfandBG). Insolvency of the cover pool is the only reason, which might trigger acceleration of Pfandbriefe.

As long as the cover pool is solvent, a moratorium on the insolvency estate cannot delay the cash flows from the cover assets and, therefore, endanger the timely payment of Covered Bond holders.

Access to liquidity in case of insolvency

Through the appointment of the cover pool administrator, the right to manage and dispose of the recorded assets is transferred to him by law (§ 30 II 2 PfandBG). Thus, the cover pool administrator has first access to the cover assets and collects the cash flows according to their contractual maturity (§ 30 III 2 PfandBG).

No explicit regulation exists with respect to the insolvency remoteness of voluntary overcollateralisation (OC). However, the insolvency administrator may only demand that the overcollateralisation be surrendered to the insolvency estate if those amounts will obviously not be necessary as cover for the respective Pfandbrief category (§ 30 IV 1 PfandBG). The burden of proof that OC will never be necessary for the timely payment of the Pfandbriefe, lays with the insolvency administrator.

The cover pool administrator is entitled to contract loans in order to obtain liquidity. According to § 30 II, 5 PfandBG, the cover pool administrator may carry out legal transactions with regard to the cover pools in so far as this is necessary for an orderly settlement of the cover pools in the interest of the full and timely satisfaction of the Pfandbrief creditors.

Pfandbriefbank with limited business activities

The amendment of the PfandBG 2010 is focusing on the legal nature of cover pools in the event of a Pfandbrief bank's insolvency and on the access of a cover pool administrator to liquid funds during difficult times. A cover pool will be given the status of a non-insolvent part of the bank of the insolvent Pfandbrief bank. Thus, the cover pool administrator could act as head of a bank in respect of transactions with the Deutsche Bundesbank; he would also be entitled to issue Pfandbriefe.

More precisely, § 2 IV PfandBG stipulates that the banking license will be maintained with respect to the cover pools and the liabilities covered there from until the Pfandbrief liabilities have been fulfilled in their entirety and on time.

A revised version of § 30 PfandBG addressing the ring-fencing of the cover assets from the insolvency estate confirms this new approach by introducing the new heading 'segregation principle' and by referring to the cover assets as 'insolvency-free estates'. Consistently, the amended PfandBG incorporates the term 'Pfandbrief bank with limited business activities'.

Thus, the amendments ensure that the cover pool administrator acts on behalf of a solvent Pfandbrief bank that is in possession of a license to engage in banking business in general and in Pfandbrief business more specifically, even if the bank itself is insolvent and the general banking license withdrawn. Hence, the Pfandbrief bank with limited business activities is treated as a solvent bank in order to comply with the eligibility criterion 'counterparty' for central bank open market operation with the perspective to satisfy its liquidity needs.

Sale and transfer of mortgage assets to other issuers

According to § 32 I PfandBG, the cover pool administrator may transfer all or a part of the assets recorded in the cover register as well as liabilities from Pfandbriefe as a whole to another Pfandbrief bank. This transfer requires the written approval of the supervisory authority.

According to § 35 I PfandBG, the cover pool administrator may also agree with another Pfandbrief bank that the assets recorded in the insolvent Pfandbrief bank's cover register may be managed in a fiduciary capacity by the insolvent Pfandbrief bank's cover pool administrator for the other Pfandbrief bank.

Thus, particular provisions allow for an easy "transfer" of mortgages outside of the common provisions of civil law, e.g. the management in a fiduciary capacity of registered land charges (so called "Buchgrundschulden") and foreign mortgages. Both forms require the written approval of the BaFin. Since 1 January 2011, § 36a PfandBG stipulates that the specific provisions of the PfandBG have priority during the restructuring of a Pfandbriefe issuing institution according to the new "Restrukturierungsgesetz".

VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

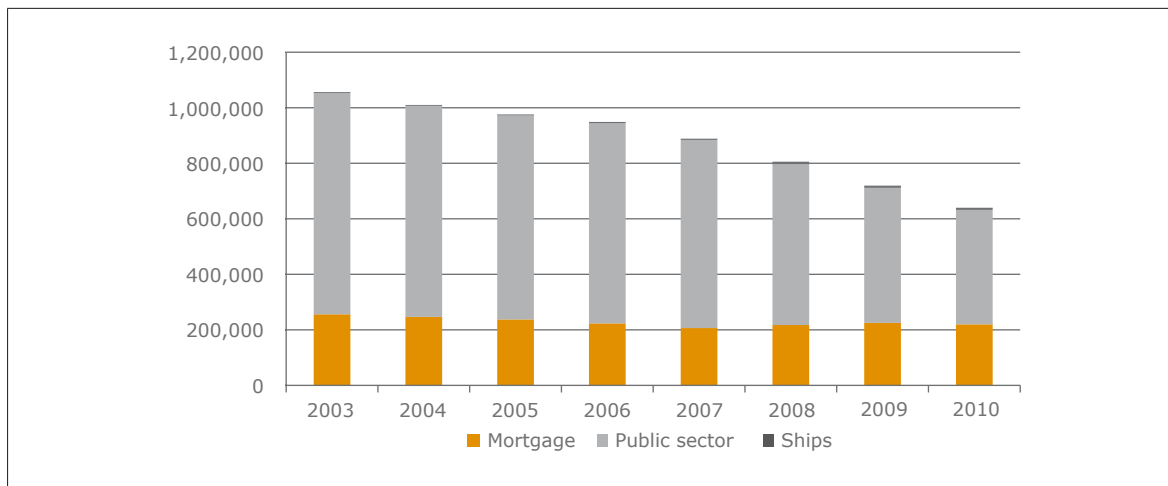
The risk weighting of Covered Bonds (German Pfandbriefe and foreign Covered Bonds) is regulated by Article 20a Kreditwesengesetz (KWG) and the Solvabilitätsverordnung (SolvV), transposing the Capital Requirements Directive into German law.

German Pfandbriefe comply with the requirements of Art. 52 par. 4 UCITS Directive as well as with those of the CRD Directive, Annex VI, Part 1, Paragraph 68 a) to f). Therefore, they enjoy a 10% risk weighting. Foreign Covered Bonds enjoy a 10% risk weighting in Germany, provided that they comply with the requirements of § 20a KWG.

Derivatives which are part of the cover pool are now 10% risk weighted, granting the derivative partners the same risk weighting as Pfandbriefe (§ 25 VIII SolvV).

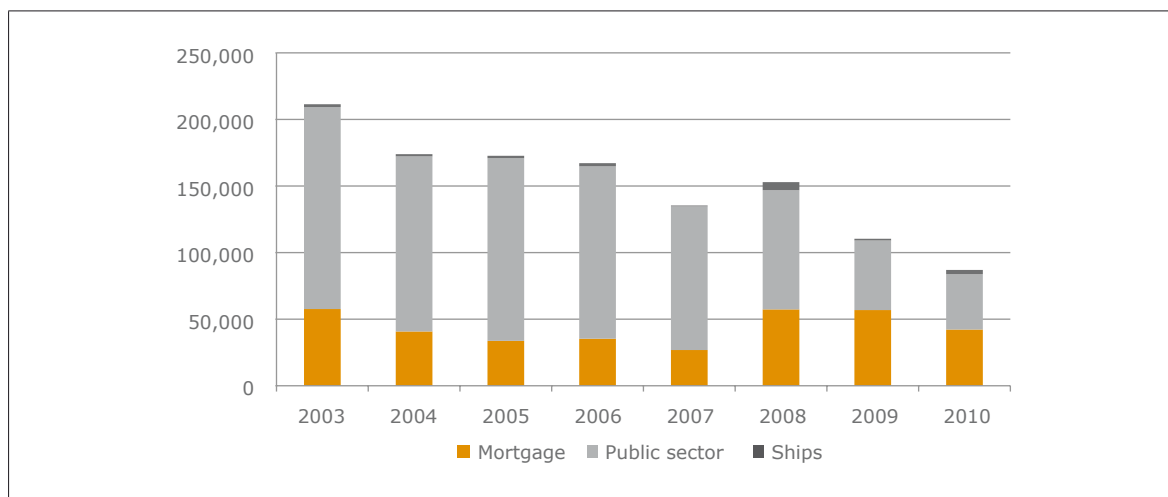
Finally, German investment legislation allows investment funds to invest up to 25% of the fund's assets in Pfandbriefe and furthermore in Covered Bonds issued by credit institutions complying with the requirements of Art. 22 par. 4 UCITS Directive (Article 60 par. 2 German Investment Act).

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC

Issuers: There are currently about 70 Pfandbrief banks in Germany, including banks from all three pillars of the German banking industry (private banks, public banks and co-operative banks). They include 18 former mortgage banks, 10 Landesbanks and circa 30 savings banks. Also, an increasing number of private universal banks became Pfandbrief banks within the last years.