Southeast Europe Financial Sector Conference

„Developing Secondary Mortgage Markets in Southeast Europe“

Sofia/Bulgaria, 4th/5th February 2003

Mortgage Banking in Germany and Europe

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Association of
German Mortgage Banks

Contents

I. History

Mortgage bond sees a renaissance in Europe

West

improve or renew systems

EMU (Euro)

different systems of mortgage banks and mortgage bonds

Central and East

mortgage banks and mortgage bonds have to be established

historic development and actual situation in Europe

problems in housing ⇒ financing required

History

1770	Silesian Landschaft, Breslau
1850	First Danish law on mortgage credit
1852	Crédit Foncier de France, Paris = 1. mortgage bank
1870	Preußische Centralboden-Credit-Actiengesellschaft, Berlin, (modern mortgage bank)
1874	Austrian Law „Concerning the safeguarding of rights of the holders of mortgage bonds“
1876	Hungarian law on safeguarding of mortgage bonds
1900	the German Mortgage Bank Act (HBG) comes into force

Historical development of the mortgage bond

mortgage

400 B. C.

Greece

17. Ent.

accessoriness

execution
artified right
certified landcharge
landregister

1770

Silesien
Landschaft
(Prussia)

Lüneburg
(1790)

Denmark (1850)

Estonia (1802)
Livonia (1803)

Courland (1832)

Russia (1861)

Netherlands (1823)

Romania (1825)

Sweden (1833)

Finland (1851)

Poland (1825/1838)

Norway
(1851)

Austria
(1841)

bond

1602 = bond issues of the Dutch
East-India-Companie

1624 = Siena
Deubtures für financing
of mortgages
bonds

sincet 1650
Bonds of note-issuing banks

1852 = Crédit Foncier de France

Germany
1862 = Frankfurter
Hypothekenbank

1900 Hypothekenbankgesetz
1927 ÖPG

Switzerland

1857 = Caisse Hypothécaire
du Canton de Genève

1930 = Pfandbriefgesetz (Mortgage Bond
Act)

Spain
(1872)

Bulgaria
(1910)

Austria with
Dalmatia,
Istria, Carniola (1874)
Bohemia
(1865)

Moravia
(1875)
Hungary, Croatia-
Slavonia (1876)

Netherlands
(1861)

Portugal
(1991)

Italy
(1866)

Greece
(1927)

England
(1865)

Romania
(1873)

Austria
(1874)

Czech Republik
(1995)

Slovakia
(1996)

Hungary
(1997)

Luxemburg
(1997)

Poland
(1928)
(1998)

Latvia
(1998)

France
(1999)

Finland
(2000)

Bulgaria
(2000)

Ireland
(2002)

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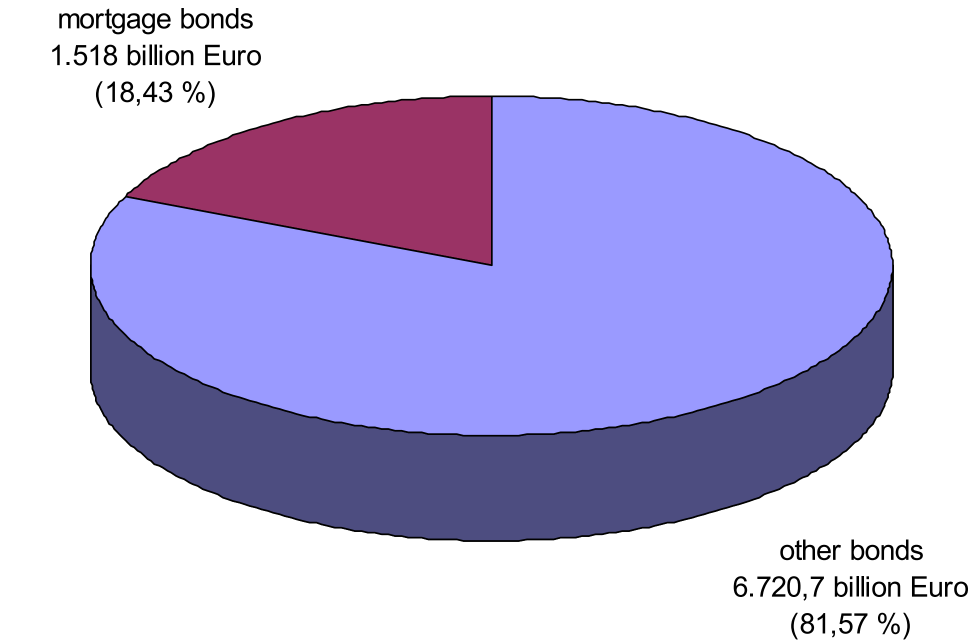
II. Mortgage Bond in Europe

1. Economic point of view

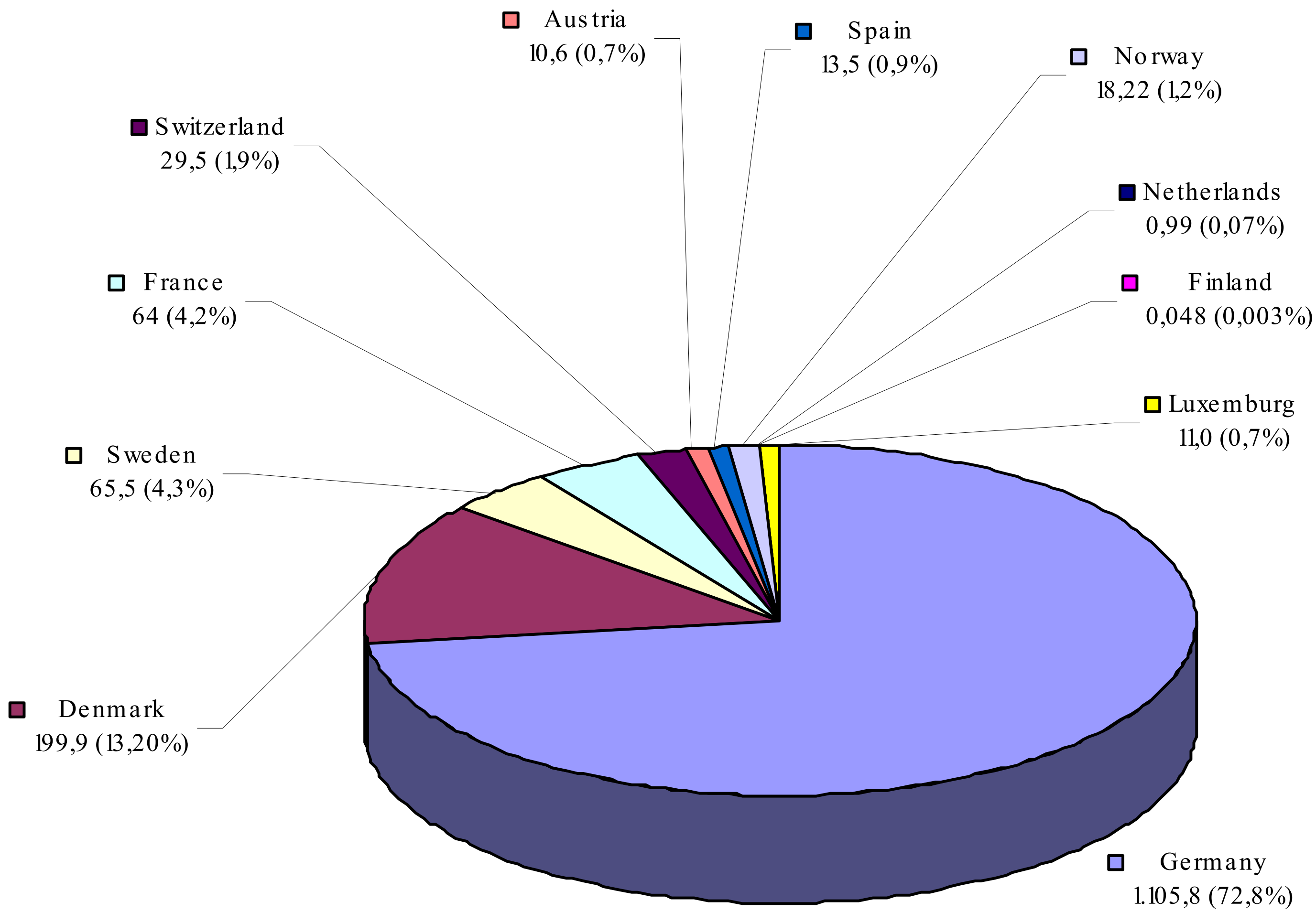
The European Bond Market:
8.238,7 billion Euro (end of 2001)



(bond market – total of all bonds, government bonds included)

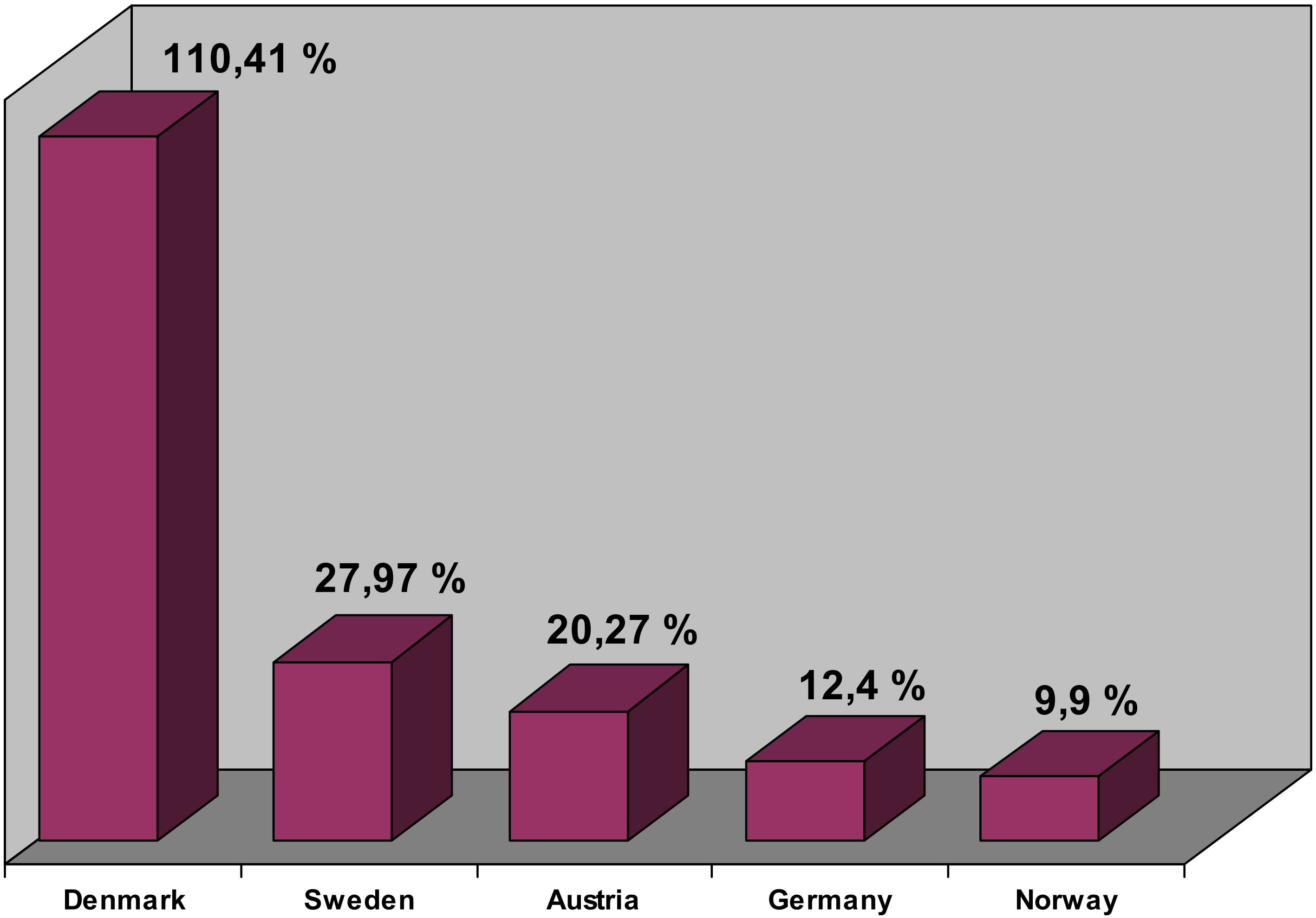
(source: Kälberer/VdH office Brussels, Merrill Lynch)

Market share of the EU-mortgage bond countries in the EU-mortgage bond market (end of 2001, in billion Euro): 1.518 bn Euro



(source: Kälberer/VdH office (Brussels), European Mortgage Federation, Brussels)

Outstanding mortgage bonds in % of GDP (end of 2000)



(source: European Mortgage Federation, Brussels)

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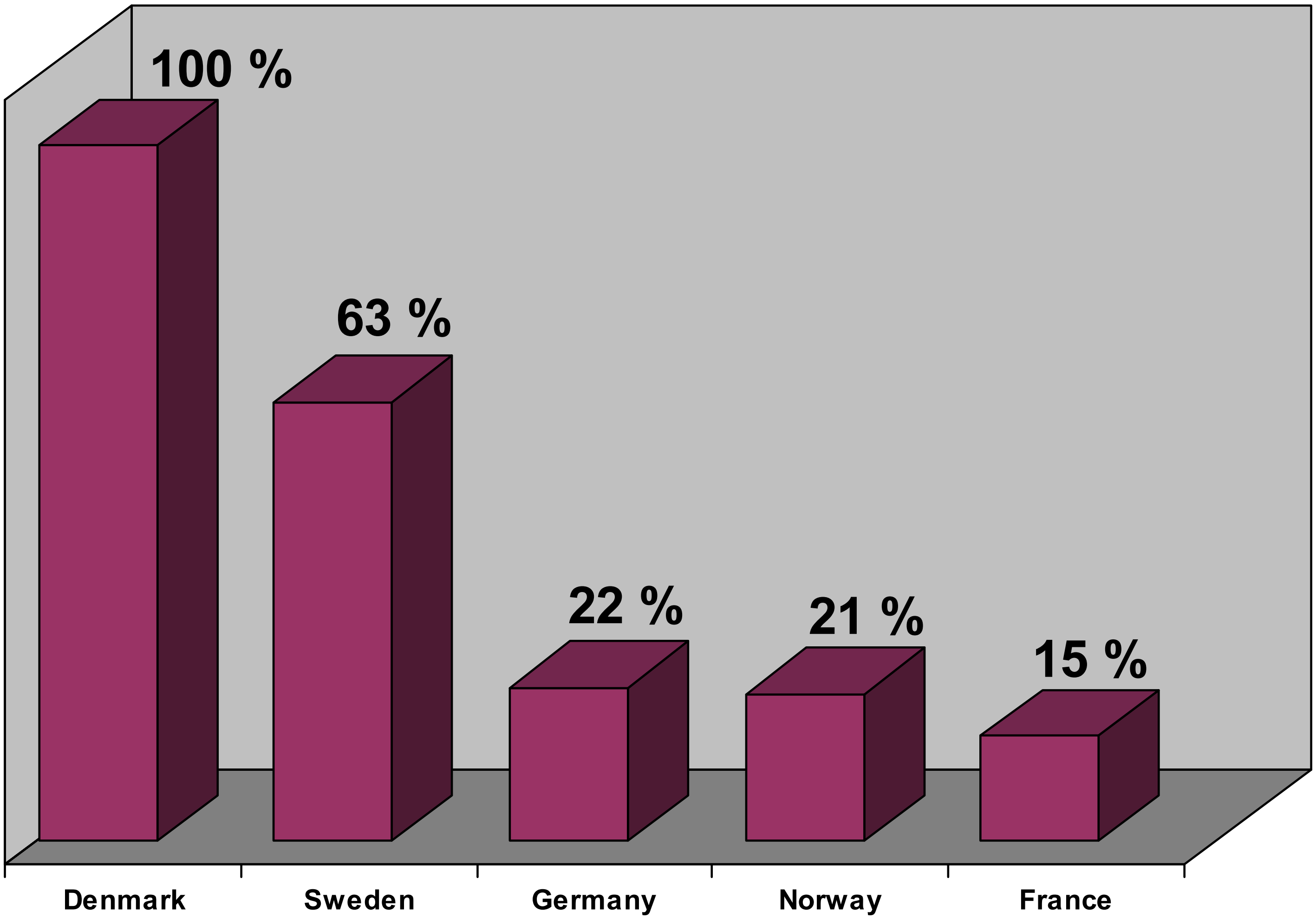
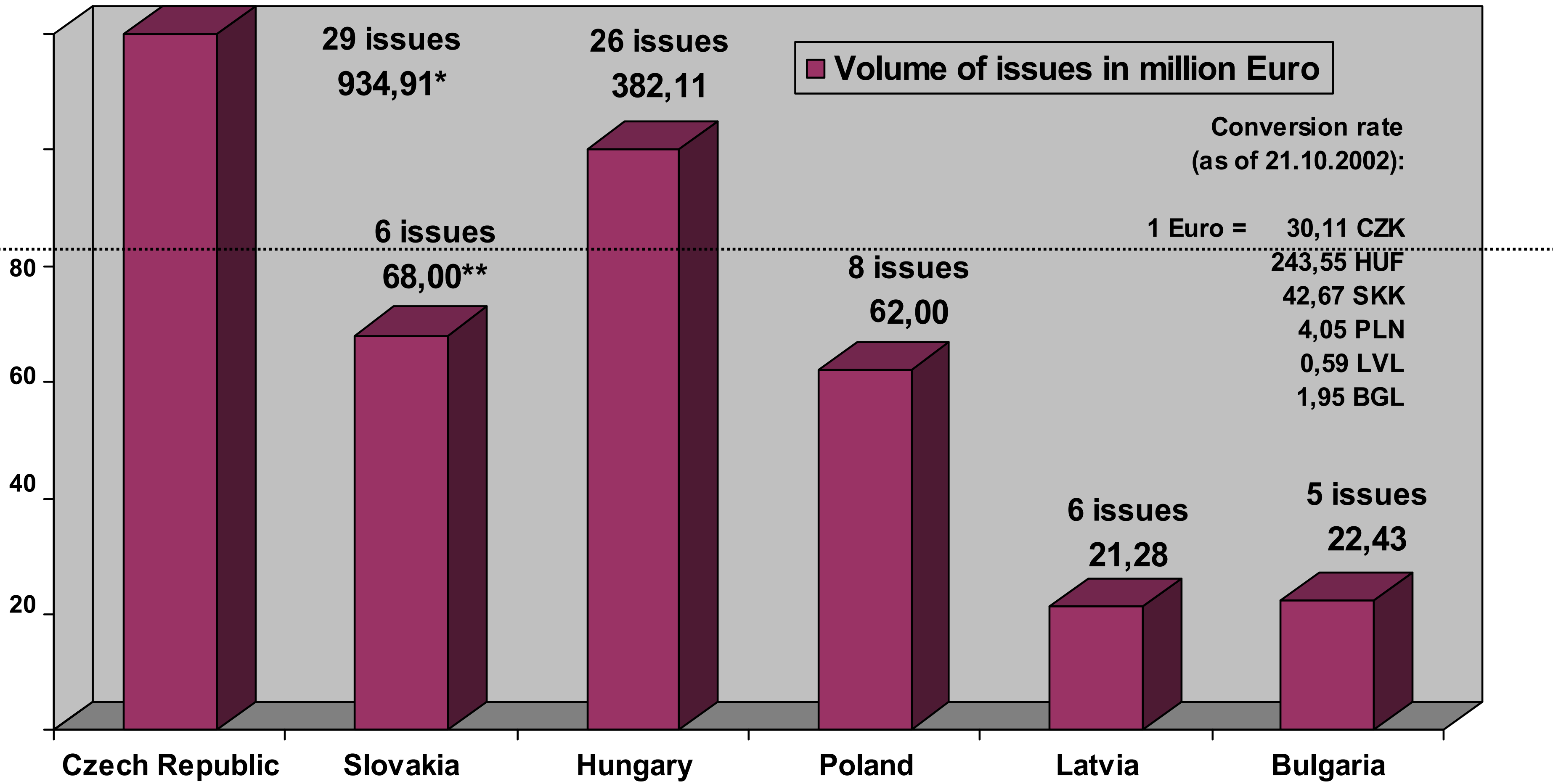
Refinancing of housing mortgage loans through mortgage bonds in EU- member states (end of 2000)



(source: European Mortgage Federation, Brussels)

Mortgage bond issues in central Europe since 1996: Czech Republic, Slovakia, Hungary, Poland, Latvia, Bulgaria (as of 15.11.2002)



*Mortgage bonds already due are not considered!

** as of August 2002

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II. Mortgage Bond in Europe

2. Legal point of view

Legal point of view

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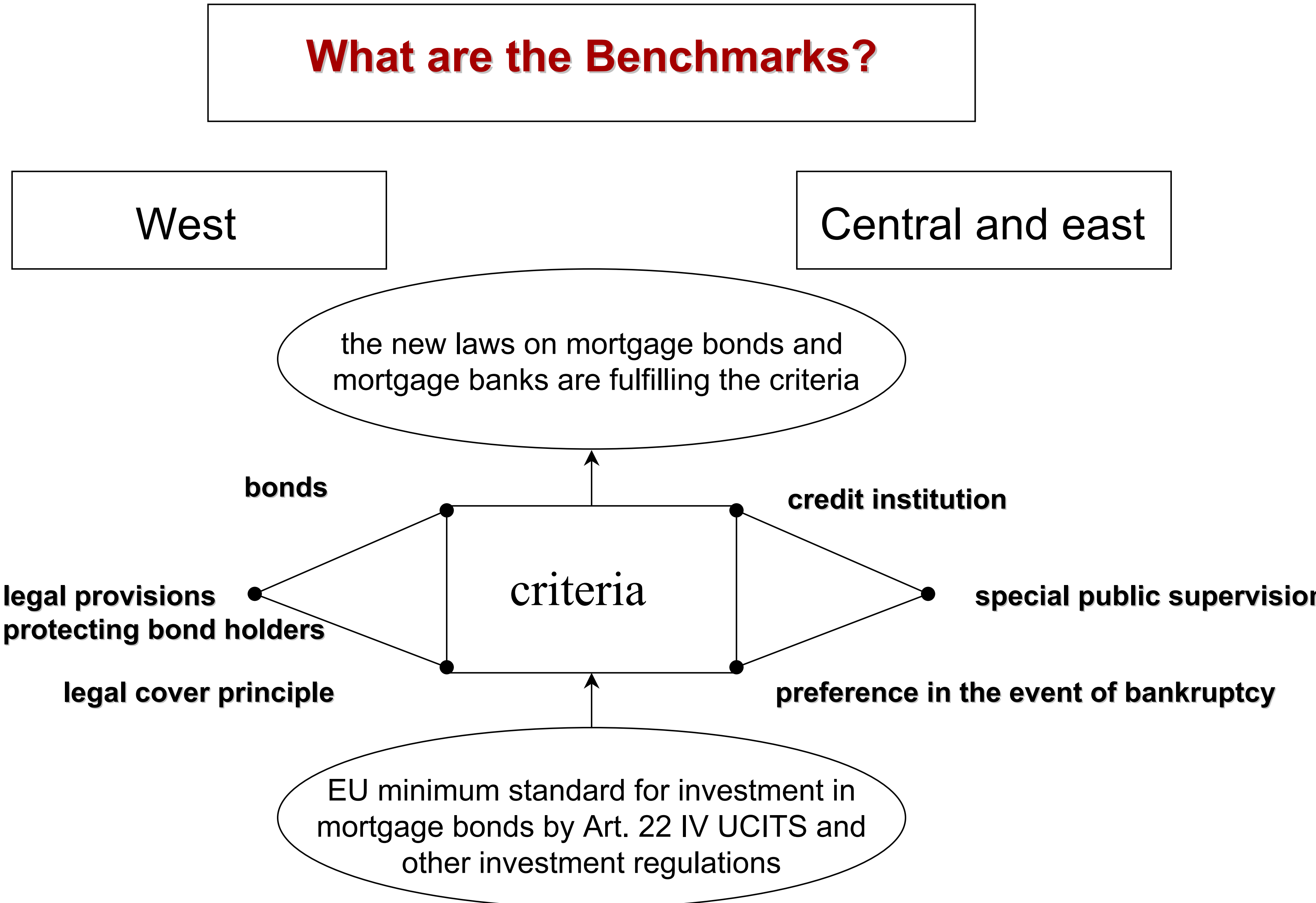
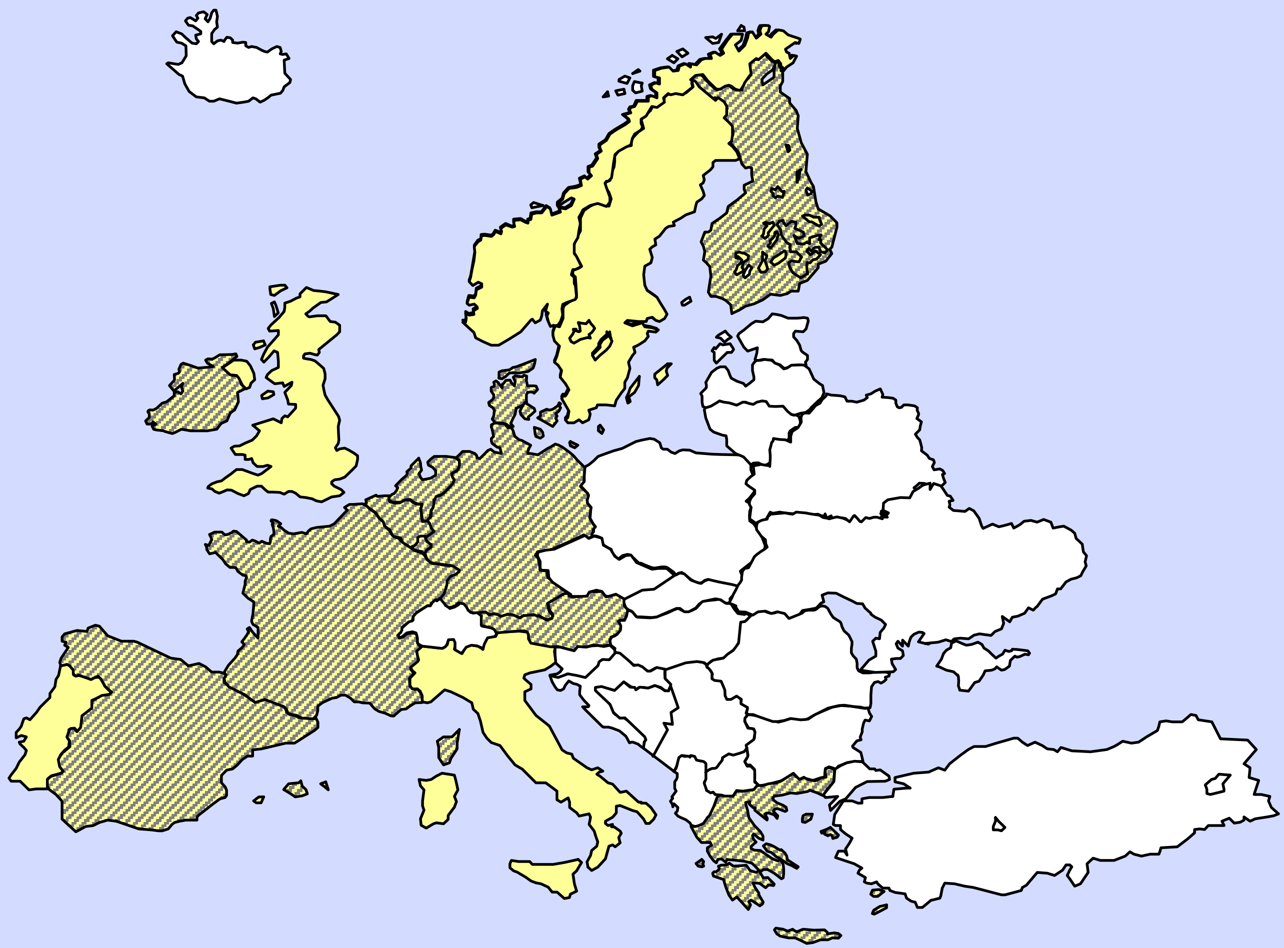


Meaning of Art. 22 IV UCITS-Directive ➔ „Mortgage bond“ as privileged investment instrument

Investment funds	Directive on life insurance companies	Directive on large exposure credits	Directive on capital adequacy	Directive on deposit insurance
funds may be invested in mortgage bond/ bonds according to Art. 22 IV UCITS: 25% instead of 5-10% in securities of one issuer	„bound assets“ may be invested in mortgage bond / bonds according to Art. 22 IV UCITS: 40% instead of 5 % in securities of one issuer	mortgage bond/ bonds according to Art. 22 IV UCITS: are not included in the calculation of the upper limit	mortgage bonds / bonds according to Art. 22 IV UCITS: have to be covered only with half of the equity	mortgage bonds / bonds according to Art. 22 IV UCITS: are excluded from the term of „deposit“

Weighting of mortgage bonds complying with Art. 63 (2) Consolidated Banking Directive 2000/12/EC (former Art. 11 II Solvency Ratio Directive), as of 12/2002



20%	Italy Norway Portugal Sweden United Kingdom	
10%	Austria Belgium Denmark Finland France Germany Greece Ireland Luxembourg Netherlands Spain	

mortgage bond = 22 IV UCITS Directive?

- no Europe-wide uniform definition of the mortgage bond
- but minimum standard for a particular safe type of a bank‘s bond, taken into account in 7 directives and in Tier I of the ECB

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• Criteria of the Art. 22 IV UCITS-Directive (investment directive/UCITS)

Bond of a credit institution that
- has its registered office in a EU-member state and
- is - due to legal provisions protecting bond-holders -
- by law subject to a special public supervision.

According to legal provisions earnings from the issue of these bonds have to be invested in assets
- which during the whole period of validity of the bonds are capable of covering claims attaching to the bonds and
- which in the event of failure of the issuer would be used on a priority basis for the reimboursement of the principle and payment of the accrued interest

Shortcomings of the Art. 22 IV UCITS-Directive

- Which assets? Not only mortgage loans and public sector loans
- Which criteria should be applied to the valuation of real estate / lending value / mortgage lending value - see differentiation in the directive on a solvency ratio for credit institutions
- Which loan to value ratio?
- cover register?
- trustee?
- special bank principle?

- conclusion: Art. 22 IV UCITS-Directive = only minimum standard for mortgage bonds

- name protection is stipulated in many countries; it has to be interpreted according to EU-law!

EU-law for mortgage bonds

- Art. 22 (4) UCITS-Directive (Investment Directive)
- Art. 49 (1) letter l); Art. 63 (2) of the Consolidated Banking Directive
- Art. 22 (4) of the 3rd Directive on life insurance companies
- Art. 22 (4) of the 3rd Directive on other insurance companies
- Art. 11 (2) of the Directive on capital adequacy for investment firms
- Art. 1 No 1 (3) of the Directive on deposit insurance
- EZB: Tier 1 (eligible as collateral)

III. German Mortgage Banking System

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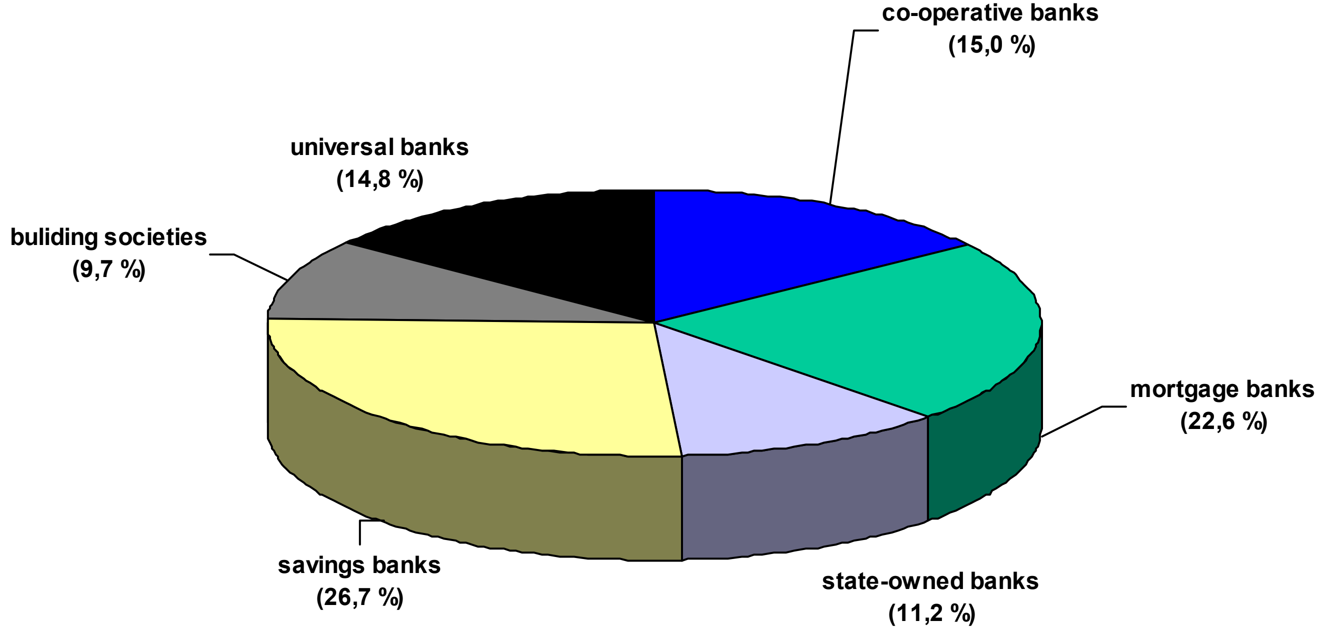
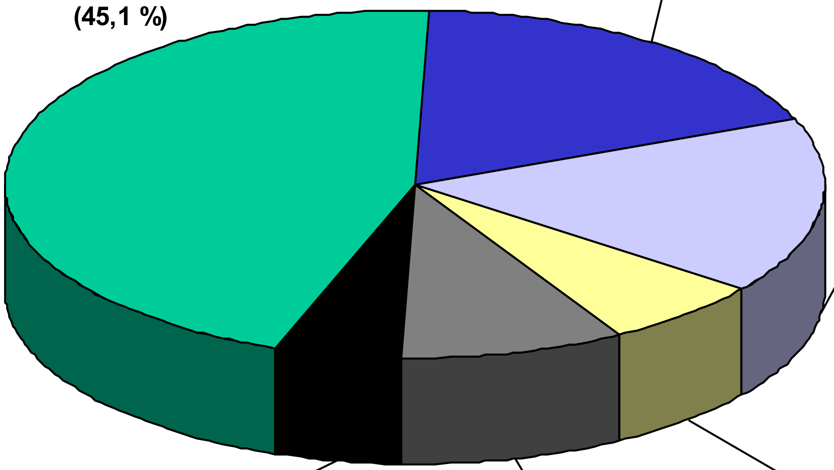
Market share of German mortgage banks in housing finance (loans outstanding, end of 2001)



total: 1.054 billion Euro

(source: VdH)

Market share of German mortgage banks in commercial mortgage lending (loans outstanding, end of 2001)



total: 223,6 billion Euro

(source: VdH)

Structure of a Mortgage Bank

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MBA

Special banking supervision
based on Banking Act and
Mortgage Bank Act

Mortgage and public-sector loans outside the cover

Business not requiring cover

Not covered bank bonds

Mortgage loans

60 % of mortgage lending value ≥

Mortgage Pfandbriefe

Public-sector loans

100 % of loans granted ≥

Public Pfandbriefe

Cover monitored by trustee

Important Features of the Mortgage Bank System

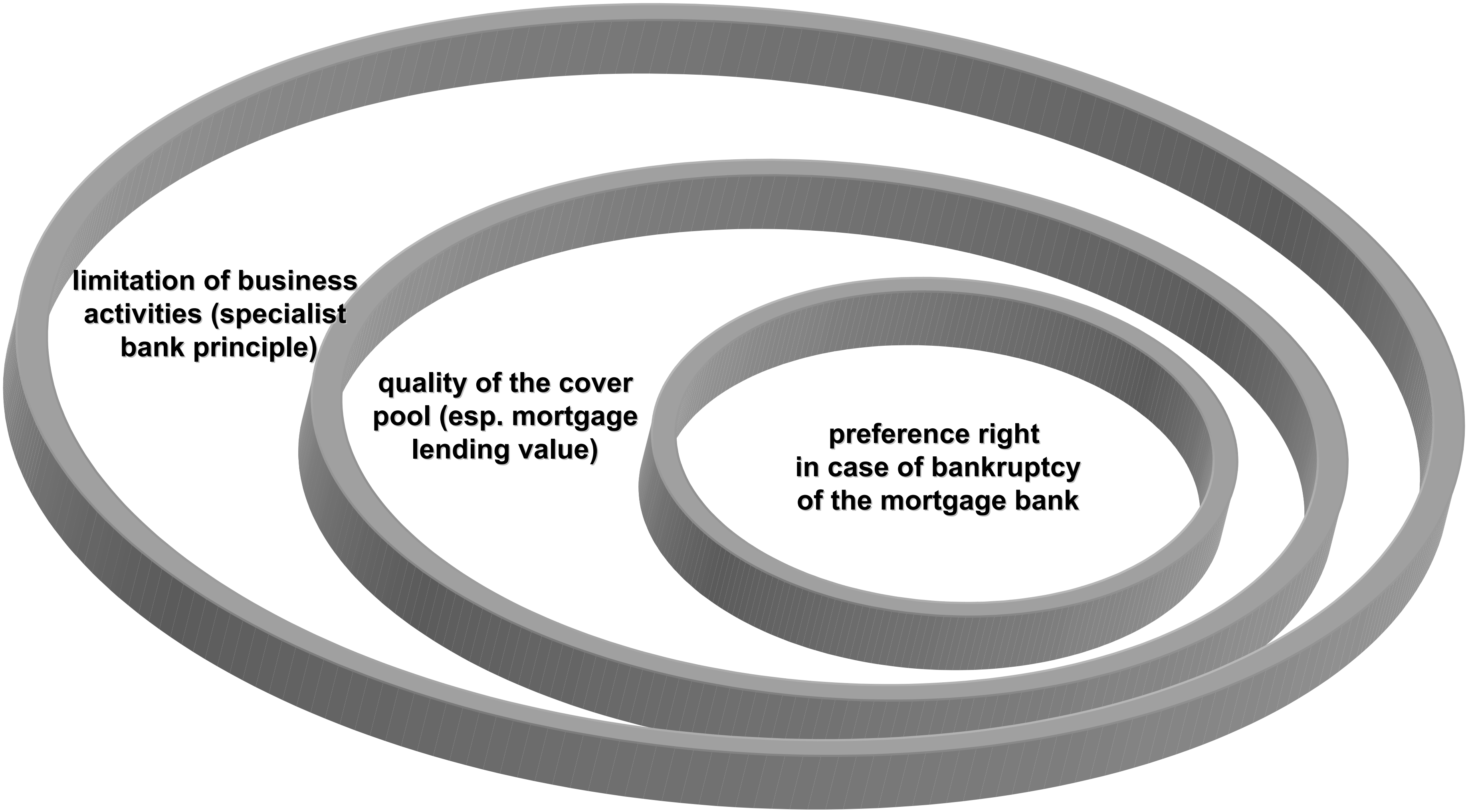
Business by banks

- same regulations as for other banks
- same capital adequacy ratios

but:

- additionally special supervision
- trustee for coverage
- limitations of business (specialisation)
- matching of assets and liabilities
- Mortgage lending value

rotective walls around the mortgage bond



(source: Volkher Kerl)

isk structure of a specialised mortgage bank

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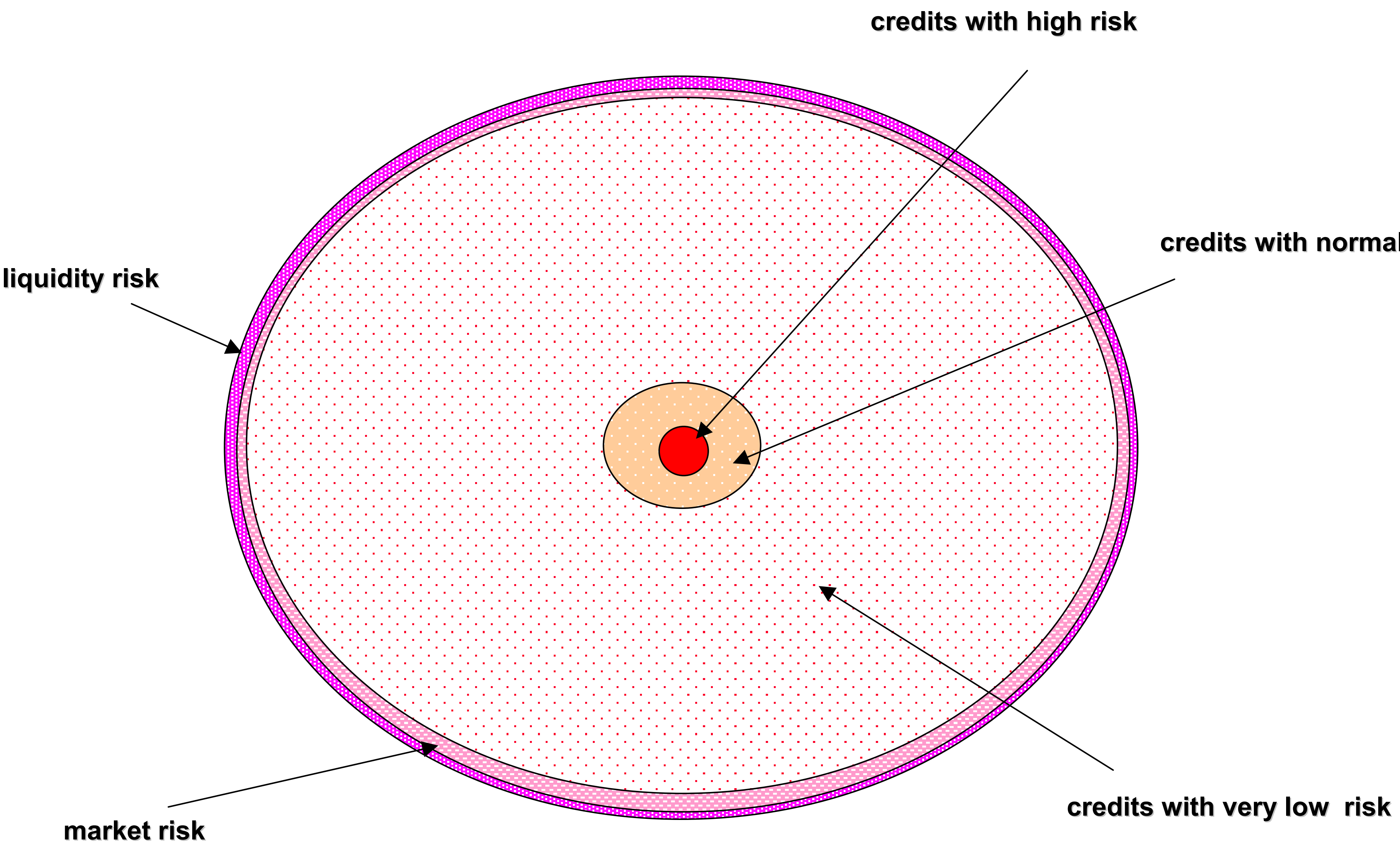

(source: Volkher Kerl)

Mortgage lending value

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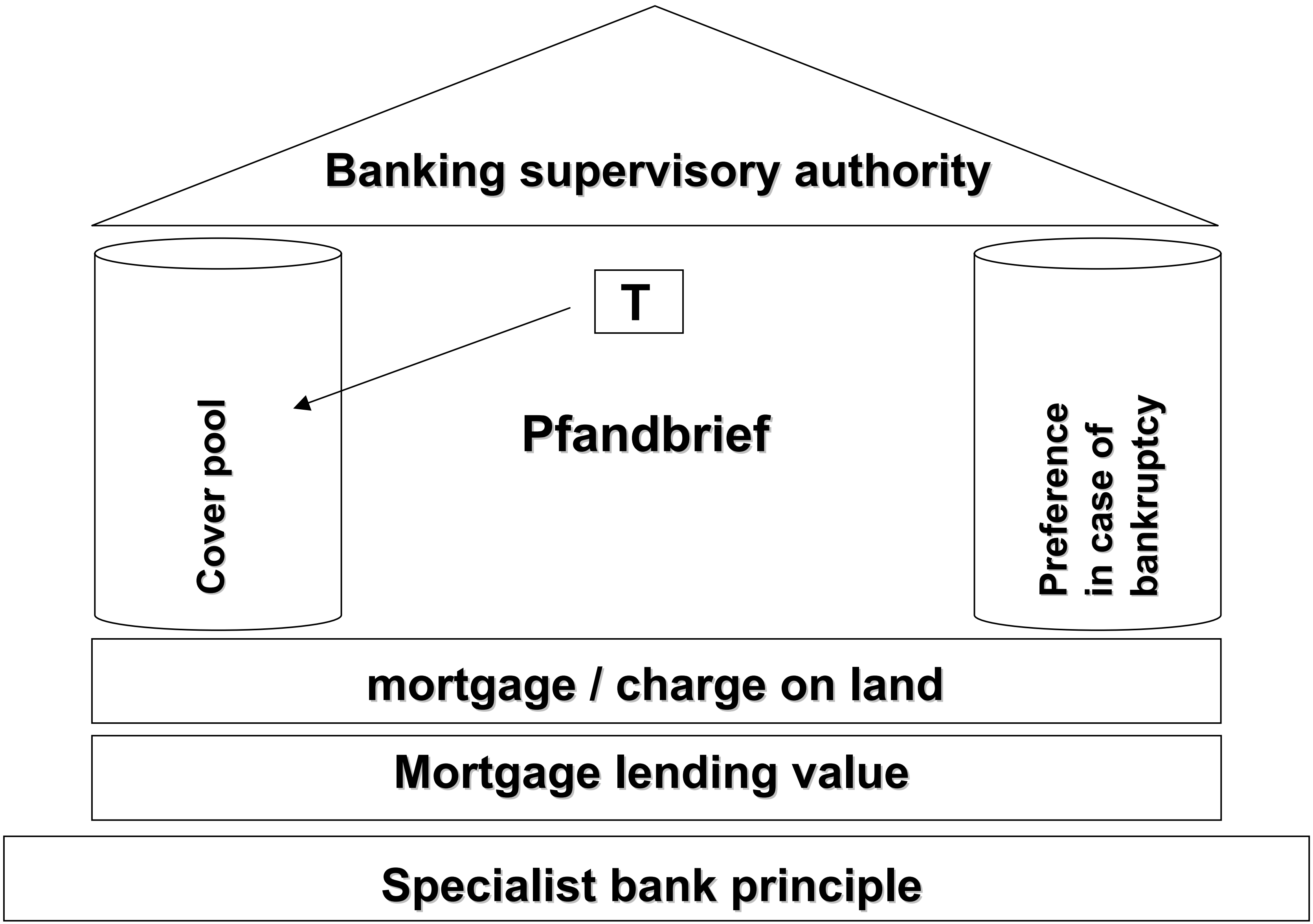
Mortgage Lending Value

- the value that can be expected with a high level of surety
- derived from the historic perspective of market events at the time of valuation,
- on the basis of durable characteristics
- and which will be achieved in normal property transactions over a lend period in the future

Sustainability

- exclusion of all speculative elements
- stabile value components, derived from the market events of the past
- only proven secured characteristics and income streams
- careful estimation of the future marketability of the particular property
- adaptability for various uses or adequate functionality to third parties

Security of the German mortgage bond



IV. Legislation on mortgage bonds in Europe

Geographical Overview of Mortgage Bank and Mortgage Bond Legislation in Europe (as of January 2003)

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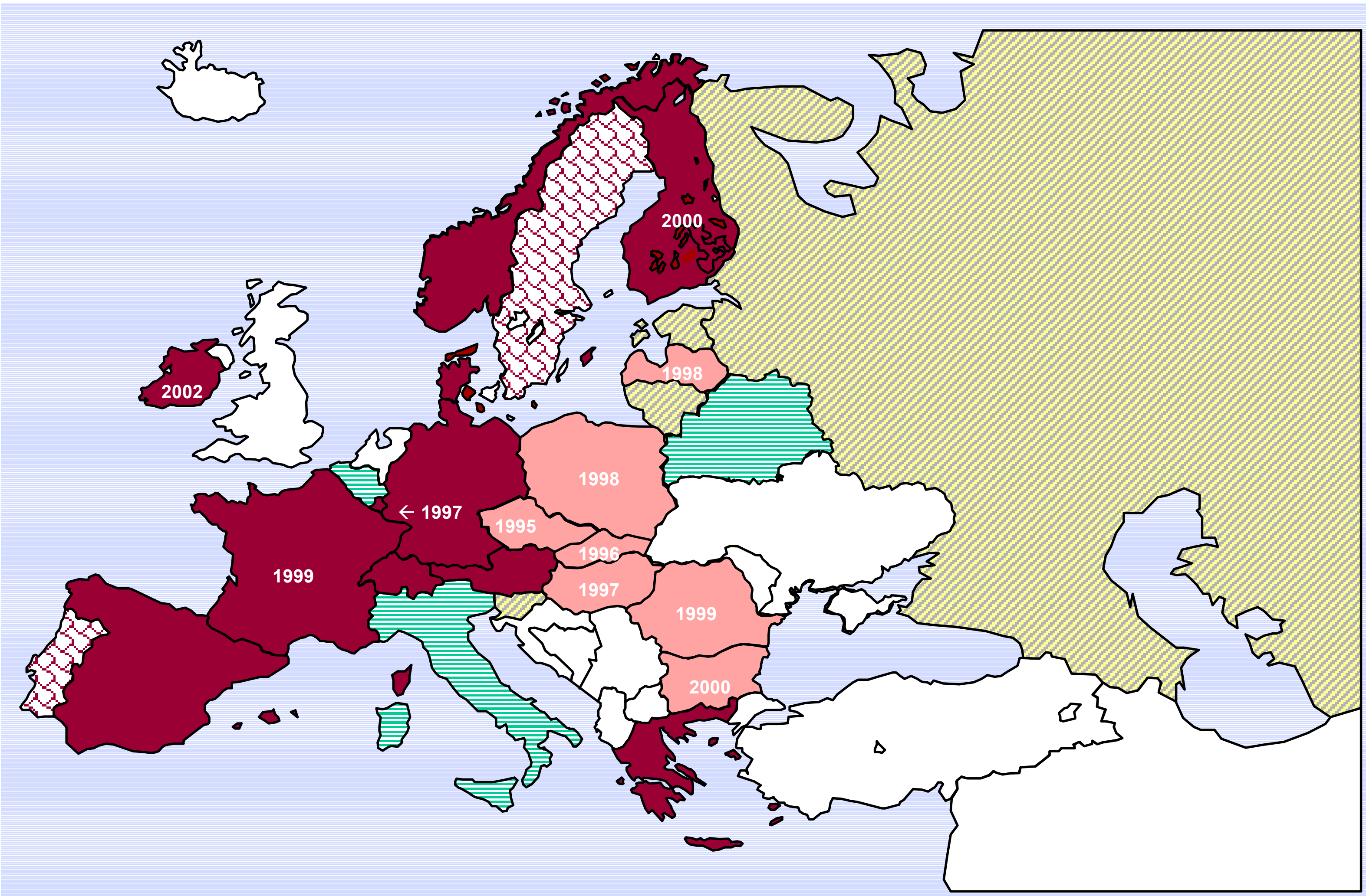

Laws on mortgage b
and „mortgage bon
in countries of th
EU/EEA

Mortgage bank and
„mortgage bonds“
legislation in potential
member countries

Concrete law
in preparation

Legislation under
consideration

existing legislation
under review fo
European standar

Comparison of Mortgage Bank and Mortgage Bond Laws in Europe with German legislation (24.9.2002) (1)

	Germany	Denmark	Greece	Switzerland	Austria	Spain	Norway
Entered into force	1.1.1900	1850 / 1989	1924	01.02.1931	01.01.1939	05.05.1981	1988
Specialist bank principle	yes	yes	yes	yes (central issuing entities)	yes	no	yes
Term protected by law	yes (Pfandbrief)	yes (realkredit-obligation)	unclear (Katharevousa-Text: κτηματκαί ομολογίαι – Transkribiert: ktimatike omolojie Translit.: ktematikai omologiai Neugr.: κτηματικές ομολογίες Transkr.: ktimatikes omolojies Translit: ktematikes omologies)	yes (Pfandbrief, lettre de gage, obligazione fondiaria)	yes (Pfandbrief)	yes (cédulas hipotecarias)	no (obligasjon)
Refinanceable through mortgage bonds	mortgage and public sector loans	mortgage and public sector loans	mortgage loans	mortgage loans	mortgage and public sector loans	mortgage and public sector loans	mortgage and public sector loans
Cover register	yes	no	yes	yes	yes	no	no
Legally anchored preferential right in bankruptcy	yes	yes	yes (but uncertain)	yes	yes	yes	no
Valuation regulations	yes	yes	yes	yes	yes	yes	no
(Relative) lending limit for funding through mortgage bonds	60 % of mortgage lending value	40/60/70/80/84 % of mortgage lending value	75 % of market value	2/3 of mortgage lending value	60 % of mortgage lending value	70/80 % of market value	mostly 80 % of market value (?)
Absolute lending limit	basically no (100 % of market value)	yes	75 % of market value	no	no	no	no
Limit for lending beyond the cover (volume above the relative lending limit)	20 %	not permitted	not permitted	no	no	no	no
Trustee	yes	no	no	no	yes	no	yes, for regular issues
Substitute collateral	yes	no	no	yes	yes	no	no
Limit for substitute collateral	10 %	no	no	no	no	no	no
Public-sector bond	yes	no	no	no	yes	yes (but not used)	yes, from other specialiszed institutions
Special ranking of cover mortgages	no	yes	no	no	no	yes	no
Special public supervision	yes	yes	yes	yes	yes	yes	no
Art. 22 (4) UCITS directive fulfilled	yes	yes	yes (but uncertain)	yes	yes	yes	no

Comparison of Mortgage Bank and Mortgage Bond Laws in Europe with German legislation (24.9.2002) (2)

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	Portugal	Sweden	Czech Republic	Slovak Republic	Hungary	Luxembourg	Poland
Entered into force	16.04.1990	1992	1.7.1995	1.3.1996	7.6.1997	19.12.1997	1.1.1998
Specialist bank principle	no	in praxi: yes	limited Pfandbrief licences	limited Pfandbrief licences	yes	yes	yes
Term protected by law	unclear (obrigaçóes hipotecárias)	no (bostads-obligationer)	yes (zástávní list)	yes (záložný list)	yes (jelzáloglevél)	yes (lettre de gage, Pfandbrief, mortgage bond)	yes (list zastawny)
Refinanceable through mortgage bonds	mortgage loans	mortgage loans	mortgage loans	mortgage and mortgage secured public sector loans	mortgage loans and, to a limited extent, public sector loans	mortgage and public sector loans	mortgage and public sector loans
Cover register	yes	no	„independent declaration“	yes	yes	yes	yes
Legally anchored preferential right in bankruptcy	yes	no	yes	yes	yes	yes	yes
Valuation regulations	yes	yes	no	yes	yes	yes	yes
(Relative) lending limit for funding through mortgage bonds	80 % of market value	60 / 75 / 85 % of value of the property	70 % of market value	70 % of mortgage lending value	60 % of mortgage lending value	60 % of mortgage lending value	60 % of mortgage lending value
Absolute lending limit	no	no	no	no	70 % of mortgage lending value	basically no (market value?)	100 % of mortgage lending value
Limit for lending beyond the cover (volume above the relative lending limit)	no	no	no	10 %	no	no	30 %
Trustee	no	no	no	yes	yes	yes	yes
Substitute collateral	yes	no	yes	yes	yes	yes	yes
Limit for substitute collateral	no	no	10 %	10 %	20%	20 %	10%
Public-sector bond	no	no	no	yes	no	yes	yes
Special ranking of cover mortgages	no	no	yes	yes	no	no	yes
Special public supervision	yes	no	yes	yes	yes	yes	yes
Art. 22 (4) UCITS directive fulfilled	yes	no	yes	yes	yes	yes	yes

Comparison of Mortgage Bank and Mortgage Bond Laws in Europe with German legislation (24.9.2002) (3)

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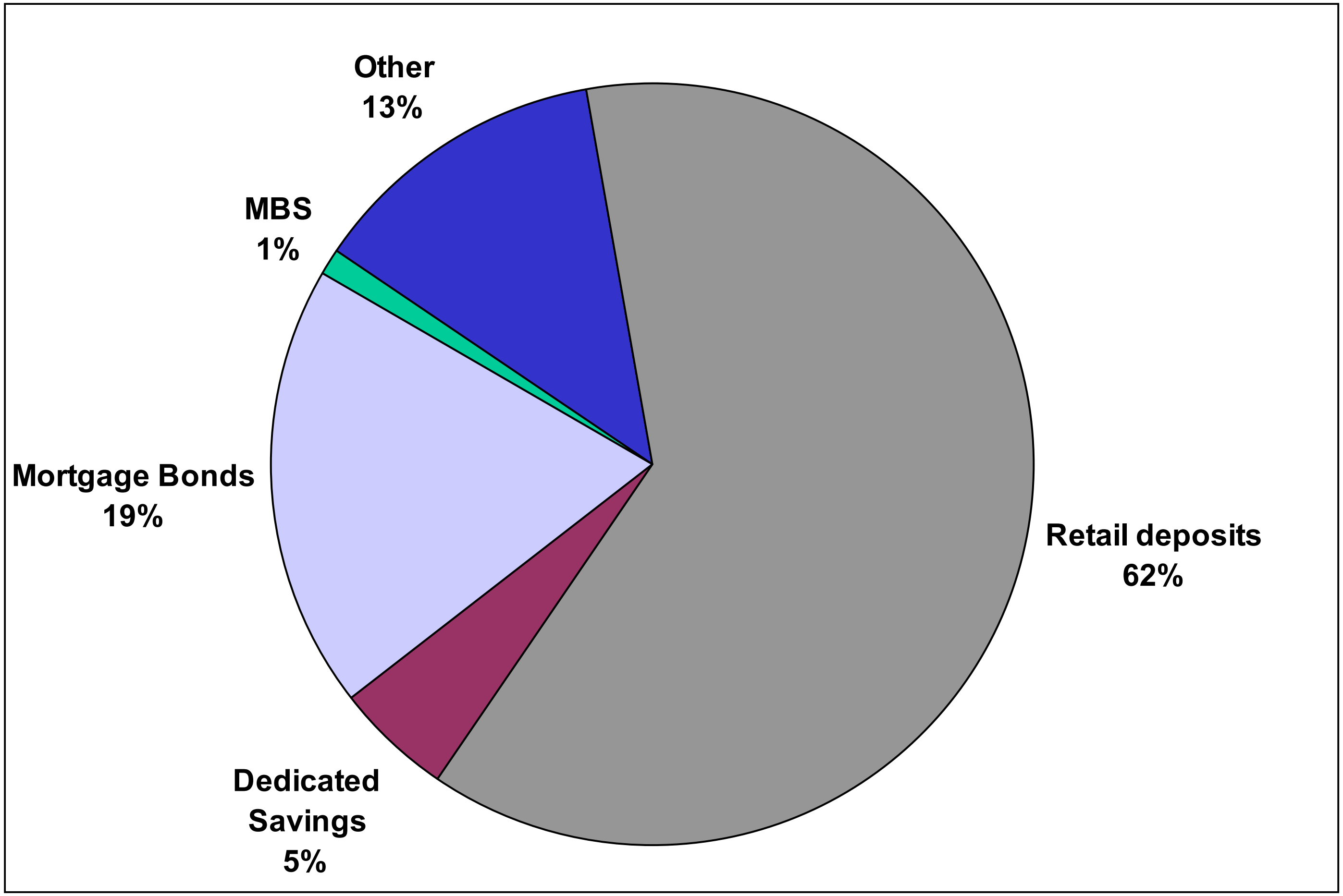
	Latvia	France	Romania	Finland	Bulgaria	Ireland
Entered into force	29.9.1998	27.07.1999	9.12.1999	1.1.2000	13.10.2000	22.3.2002
Specialist bank principle	limited Pfandbrief licences	yes, but no staff permitted	unclear	yes	no	yes
Term protected by law	yes (ķīlu zīme)	yes (obligation foncière)	unclear (obligațiunile ipotecare)	yes (kiinteistövakuudellinen joukkovelkakiryeslaina, julkisyhteisöva-kuudellinen joukkovelkakiryeslaina)	yes (ипотечна облигация ipotečna obligaciyes)	yes (mortgage credit covere security, public credit covered security)
Refinanceable through mortgage bonds	mortgage loans	mortgage and public sector loans and loans guaranteed by banks or insurances	mortgage loans	mortgage and public sector loans	mortgage loans	mortgage and public sector loans
Cover register	yes	No	no	yes	yes	yes
Legally anchored preferential right in bankruptcy	yes	yes	no	yes	yes	yes
Valuation regulations	yes	yes	no	yes	yes	yes
(Relative) lending limit for funding through mortgage bonds	60 % of market value	60 / 80 / 100 % of mortgage lending value / market value	60 % of value of portfolio	60 % of mortgage lending value	60 / 80 % of market value	60 / 75 % of the prudent market value
Absolute lending limit	no	60 / 80 / 100 % of mortgage lending value / market value	no	basically no (market value?)	no	yes (80 % of the prudent market value)
Limit for lending beyond the cover (volume above the relative lending limit)	no	no	unlimited	1/6	no	yes (10 %)
Trustee	no	yes	no	no	basically no	yes
Substitute collateral	yes	yes	no	limited in time	yes	yes
Limit for substitute collateral	20 %	20 %	no	no	30 %	20 %
Public-sector bond	no	yes	no	yes	no	yes
Special ranking of cover mortgages	no	no	no	no	no	no
Special public supervision	yes	yes	no	yes	unclear	yes
Art. 22 (4) UCITS directive fulfilled	yes	yes	no	yes	unclear	yes

V. Funding through Mortgage Bonds and MBS

Funding methods used in the EU
(% based on volumes outstanding, end-1998)



(source: European Mortgage Federation)

Mortgage Bonds are not MBS!

	Mortgage Bonds	MBS
Balance Sheet Treatment	On-balance sheet	Generally off-balance sheet
Source of Principal and Interest Payment	Issuer's cashflow	Collateral cashflow
Collateral Pool Structure	Dynamic pool of infinite life	Secured by a pool of assets that are (in general) not substitutable
Collateral	Secured by a pool of assets of equal amount and equal average maturity which are substitutable	Secured by a pool of assets that are not substitutable
Pool Loans	Heterogeneous pools	Homogeneous pools
Rating	Dependent on rating of issuing bank and volume of underlying assets	Dependent on quality and overcollateralization of underlying asset and/or quality of guarantor
Risk Weighting	10% in D, A, DK, F, E, B, SF, GR, L, NL, IRL 20% in other countries	0% GNMA 20% other agencies 50% or 100% non-agency
Principal Redemption	Bullet form	Amortisation and prepayment

Basic Principles in the USA and Europe

US

- **debundling of credit processing**
  - originator
  - servicer
  - agency
- **assets separated in a SPV (but GSE's take some share of balance)**
- **no specific supervision for MBS**
- **special supervision for GSE's**
- **no capital adequacy requirement for MBS SPV's**
- **lower capital requirement for GSE's**

MBS
state agencies
subsidies in system (via state agencies)
system strictly for housing
overall standardisation driven by agencies

Europe (Mortgage bond)

- **credit processing by one party**
  - bank
- **assets remain on balance sheet**
- **banking supervision**
- **additional supervision for mortgage banks**
- **general capital adequacy ratios**

Mortgage bond
Mortgage bond market
housing subsidies directly to borrower
housing finance only part of the system
individual decision by banks

Why is the German Pfandbrief-based Funding System for Mortgage Business so Efficient?

Reasons for High Efficiency (I)

- Long-term funding as prerequisite for long-term lending, which is typical for Germany
  ➔ Stability of German real-estate market based on “long term culture”

- Direct link between funding side (Pfandbrief) and lending side (cover pool) guarantees
  ➔ funding of loans via capital markets
  -efficient risk-based pricing
  -efficient capital allocation

- Competitive system (a number of competing banks regulated by a special law) without active state intervention compared to centralised institution subsidised by the state
  ➔ Competition guarantees low refinancing costs for borrowers

Reasons for High Efficiency (II)

- High security of the Pfandbrief as a funding instrument due to special legal framework guarantees low funding costs
  ➔ passed through to the borrowers

- Pfandbrief investors are offered
  ➔ safe base investment for fixed-income portfolios
  ➔ specific risk profile based on a highly diversified real estate portfolio
  ➔ diversification opportunity

- Capital markets profit as the Pfandbrief operates as
  ➔ Highly liquid credit benchmark used for pricing of other products
  ➔ Surrogate to sovereign bonds
  ➔ Hedging tool

...And What Does That Mean for Securitisation in Germany?

Securitisation Market in Germany Still in its Infancy (I)

Securitisation in Germany is still in its infancy. Signs are:

- relatively low yearly issuance volume
- low outstanding volume
- specific „portfolio-driven“ transactions are still the rule
  - highly specific structures based on specific portfolio needs
- lack of standardisation of issues
  - Relatively low transparency
  - low liquidity
  - difficult pricing
- Mortgage banks as dominant group of issuers

Securitisation Market in Germany Still in its Infancy (II)

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Reasons:

- Efficiency of Pfandbrief-based funding system
  - Existing market structure hinders development of large and liquid securitization market
  - Lack of central agency (as in the US) with explicit or implicit state backing
    - consequence: difficulty to create standardised high-volume market for securitisations
- Tax issues prevent true-sale transactions in Germany (trade tax)
- Sale of assets problematic as borrower has to be informed about the transfer, new holder of the mortgage (SPV) has to be registered in the Land Registry
- Question of bankruptcy remoteness of the SPV
- Basic legal framework allowing securitisation only created in 1997 by Federal Supervisory Authority

Securitisation Market in Germany Still in its Infancy (III)

Consequences:

- low overall issuance volume (see above)

- synthetic securitisation dominates
  - risk-management-tool
  - portfolio-management-tool
  - but normally no direct funding through MBS issuance

- a number of different formats have appeared in the market
  - Fully-funded synthetic structures
  - Partially-funded synthetic structures
  - „Provide“ structure of KfW
  - True-sale structures

Types of Securitisations in the German Market (I)

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1. Fully-funded structure (Synthetic)

- Assets remain on the balance sheet of the originating bank
- Outplacement of risks exclusively via credit-linked notes
- SPV may or may not be used
- Aims:
  - Regulatory capital relief
  - Management of portfolio risk
- Structures vary from transaction to transaction
- Examples:
  - Europa One, Europa Two
  - Bauhaus
  - Eurohypo 2000-1

Types of Securitisations in the German Market (II)

2. Partially-funded structure (Synthetic)

- Assets remain on the balance sheet of the originating bank
- Outplacement of risks via
  - Credit derivatives (top 85-90%)
  - Credit-linked notes (junior part)
- SPV may or may not be used
- Aims:
  - Regulatory capital relief
  - Management of portfolio risk
- Structures vary from transaction to transaction
- Examples:
  - HVB Real Estate 2001-1

Types of Securitisations in the German Market (III)

3. PROVIDE Structure of KFW (Synthetic)

- Assets remain on the balance sheet of the originating bank
- Outplacement of risks via
  - Bank guarantee (towards KfW)
  - Credit derivative and Credit-linked notes (by KfW)
- SPV is used
- Aims:
  - Regulatory capital relief (0% because of KfW – agency type issuer)
  - Management of portfolio risk
- Standardised structure but different originators (first multiseller structure was launched in November 2002
- Examples: Provide-A-2002-1 plc.

Types of Securitisations in the German Market (IV)

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4. True-sale structures

- Assets are transferred from the balance sheet of the originating bank
- SPV is used
- Aims:
  - Regulatory capital relief
  - Management of portfolio risk
  - Funding of securitized portfolio
- Portfolio-specific structures (very few due to legal difficulties)
- Examples:
  - GEMS-transaction (RHEINHYP)
  - HAUS 1998-1 (Deutsche Bank)

Conclusion:
Secondary Mortgage Market in Germany yet to be created

Conclusion (I)

- On-balance sheet funding dominates in Germany due to
  - ➔ existing and efficient Pfandbrief system
  - ➔ Legal uncertainties surrounding MBS
- Increasing importance of securitization in recent years resulting from
  - ➔ creation of legal framework by supervisor
  - ➔ increasing importance of risk management within banks
  - ➔ increasing need for capital relief
- But: European Securitization market differs from US counterpart:
  - ➔ Dominance of synthetic structures
  - ➔ Lack of transparency and standardisation
  - ➔ Lack of dominant issuer

Conclusion (II)

Consequence:

- Assets generally remain on the balance sheet of the originator
- Only the risk of a specific portfolio is tranferred to the capital markets (or bilaterally via credit derivatives to specific counterparties)
- Growing market for mortgage portfolio risk
  ➔ Through Pfandbriefe backed by mortgage portfolios
  ➔ Through CLNs
  ➔ Through Credit derivatives
  But:
  ➔ Real secondary market for mortgages comparable to US does not exist.

Further information and material offers our website:

in German:
www.hypverband.de
„Europa + G7“

in English:
www.pfandbrief.org
„Europe + G7“