Specialization of Covered Bond Issuers in Europe

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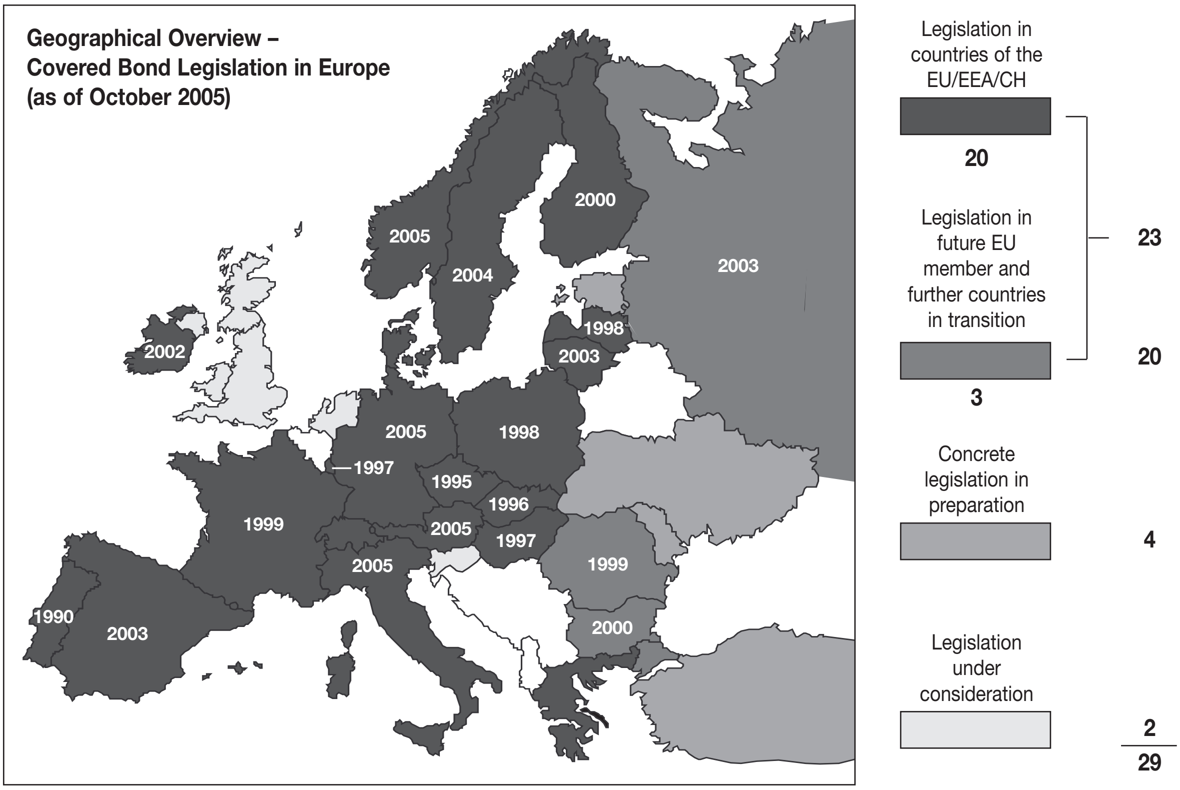
Today, the covered bond is Europe's most important non-state capital market instrument. By the end of 2004, the total volume of outstanding covered bonds amounted to EUR €1.6 billion, or 15 per cent of the European capital market.[1] In Europe, 30 countries have either introduced, or are considering introducing, legal provisions governing the issue of covered bonds (see illustration 1).

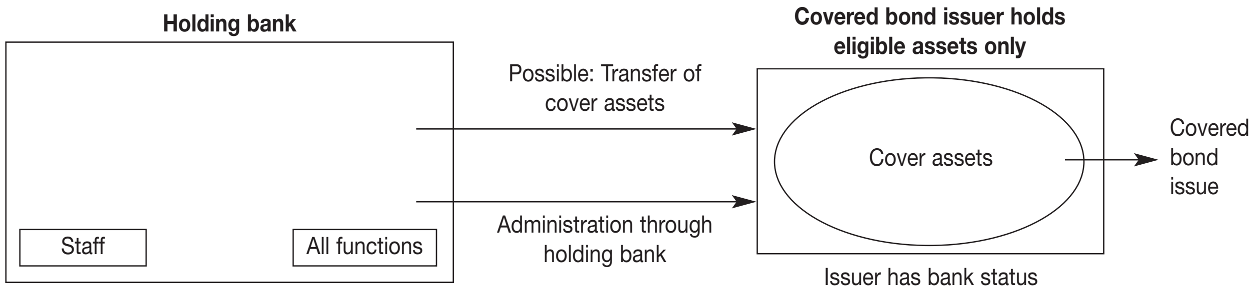
One question that always arises during discussions on the introduction of covered bond systems or their structures is that of the specialization required on the part of the issuer. The number of countries which prescribe specialization as a legal requirement and those that in principle give all financial institutions the right to issue covered bonds is almost equal, although the forms of specialization can differ considerably. The degree of specialization varies and even in those countries which do not have a specialist bank principle, not all

Illustration 1: Covered bond systems in Europe



[1] Source: European Mortgage Federation (www.hypo.org) and European Covered Bond Council (http://ecbc.hypo.org).

Illustration 2: Issuer as an issuance vehicle



banks are permitted to issue covered bonds without restriction.

This paper looks at the different types of specialization and, in the second half, outlines how under the new Pfandbrief Act of July 19, 2005 new Pfandbrief quality assurance regulations replace the 105 year-old specialist bank principle of the mortgage banks in Germany.

I. Covered Bonds Models with Different Types of Issuer Specialization[2]

Originally “specialization” meant restricting the range of business activities of Pfandbrief issuers to a small number of businesses with a low risk.[3] However, as legislation has developed in Europe, the original definition has moved on in recent years. In addition to restricting fully functioning financial institutions to specific fields of activity, the increasingly important matter of segregation of the cover pool in the event of insolvency and their transferability to other issuers has come to the fore.

These different approaches have in the meantime led to a wide range of different types of specialization in Europe, some of which are aimed at better protecting and isolating the cover funds under insolvency law, others at making the issuer bankruptcy remote, but most of which aim to do both. These forms of specialization and their advantages and disadvantages are described below.

The overview will start with the most highly specialized models and then explain the other structures which feature less specific specialization.

1. Issuers as Issuance Vehicles

This model is based on the concept of largely separating the issue of covered bonds from the generation of assets. This is carried out by splitting new business acquisition (origination) and the issue of covered bonds into two different legal bodies.

In this instance the issuer is only a funding vehicle, similar to an SPV, but does have a banking license and is subject to banking supervision. However, it has no employees of its own or other funds with which to operate a banking business. All functions are carried out by the parent bank. The

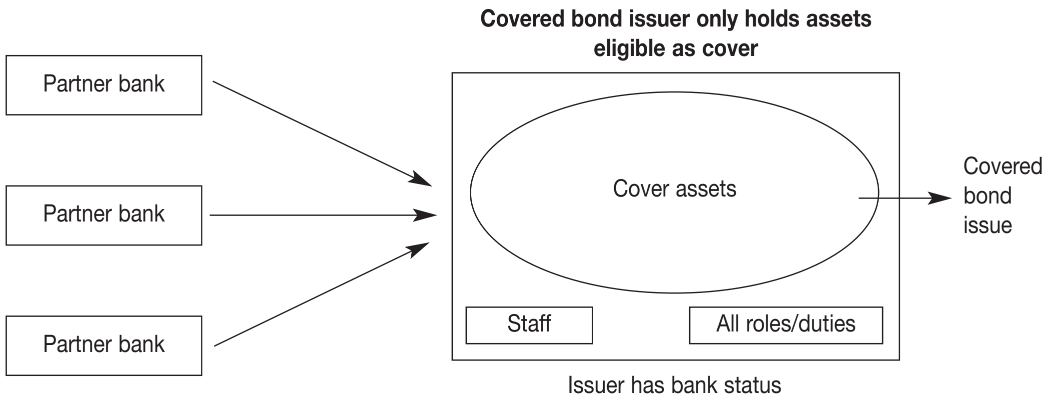
Table 1. Advantages and disadvantages of the issuer as an issuance vehicle

Advantages	Disadvantages
• High degree of specialization • Easy to supervise • Straightforward separation of funds in the event of insolvency • Low costs	• In actual fact a “mixed bank” with a legally separate cover pool in the event of insolvency • Parent bank is not a specialist in → typical mortgage bank business processes because of being a universal bank → the development of a low risk culture

[2] See also Jahresbericht des Verbandes deutscher Hypothekenbanken (Deutsch) 2004, p. 82 – 86; Nasarre-Aznar, Sergio/Stöcker, Otmar: Covered Bonds in Europe; in: de Vries Robbé, Jan Job/Ali, Paul U.: Securitisation of Derivatives and Alternative Asset Classes – Yearbook 2005, The Hague 2005, p. 167 – 206 (esp. p. 175 – 183)

[3] Source: Bellinger, Dieter/Kerl, Volkher: Hypothekenbankgesetz-Kommentar, 4. A. Munich 1995; Section 1 number 12

Illustration 3: Centralized issuer



subsidiary is restricted to accepting assets eligible as cover and funding them through covered bonds.

This model is used in France[4], Ireland[5], Finland[6], Norway (future)[7] and to a certain extent in Sweden[8].

2. Centralized Funding Institution

Centralized funding institutions[9] are used in Switzerland (Pfandbriefbank[10] and Pfandbriefzentrale[11]), Austria (Pfandbriefstelle[12]) and France (Caisse de Refinancement de l'Habitat, CRH). In Austria and France, these institutions exist alongside other covered bond issuers.

The member banks sell or pledge their mortgage loans to the centralized institutions, which in turn issue covered bonds for funding purposes. In Austria, the members themselves can also issue Pfandbriefe, whilst in Switzerland they may not.[13]

Table 2. Advantages and disadvantages of a centralized issuer

Advantages	Disadvantages
• Low costs	• Monopoly
• Employees are risk aware	• Political influence
• Bigger issues	• Co-operation between competitors: – business secrecy – strategy and structure of terms and conditions

[4] Source: Kälberer, Wolfgang: Das französische Gesetz über die Sociétés de Crédit Foncier; Der langfristige Kredit 1999, p. 634 - 637

[5] Source: Jahresbericht des Verbandes deutscher Hypothekenbanken (Deutsch) 2002, p. 80 f.

[6] Source: Stöcker, Otmar: Das neue Hypothekenbankgesetz in Finnland; Der langfristige Kredit 2000, p. 544 - 546

[7] Source: Lassen, Tim: Neue Regelungen zum Pfandbrief und zu Hypothekenbanken in Norwegen; Immobilie & Finanzierung 2004, p. 48 – 52
The new Norwegian law is scheduled to come into force at the end of 2005.

[8] The Swedish law came into force on July 1, 2004. Covered bonds previously issued by Swedish mortgage banks must be converted into covered bonds under the new legislation, if the new issues should be done according to this new law, see: Stöcker, Otmar: Neues Gesetz über Covered Bonds in Schweden; Immobilie & Finanzierung 2005, p. 301 - 305

[9] The question of the state's participation in a centralized funding institution is commented on in a separate paper.

[10] www.pfandbriefbank.ch

[11] www.pfanbriefzentrale.ch

[12] www.pfandbriefstelle.at; see also Lassen, Tim: Pfandbriefe und fundierte Schuldverschreibungen in Österreich, Immobilien & Finanzierung 2005, p. 374 – 381, especially p. 377)

[13] It is important to note that Swiss legislation has created two centralized institutions for reasons of competition and that neither receives a state guarantee or other public subsidies. They are not owned by the state, but by the partner banks they fund.

3. Specialist Bank With/Without Low Volume of Non-Cover Business

This model is based on the classic specialist bank principle, ie the issuer must limit itself exclusively or primarily to cover business. Traditionally this principle has been used to protect covered bond creditors as it aims to reduce the risk of the issuer becoming insolvent since the issuer only operates, or operates primarily, in particularly secure mortgage business. The mortgage banks can, but do not have to, work with partner banks in their lending operations or be part of a banking group.

This model is used in Denmark[14], Poland[15], Hungary[16], Luxembourg[17] and to a certain extent in Sweden. Until July 19, 2005 this was also the statutory model in Germany.

Illustration 4: Specialist bank with/without low volume of non-cover business

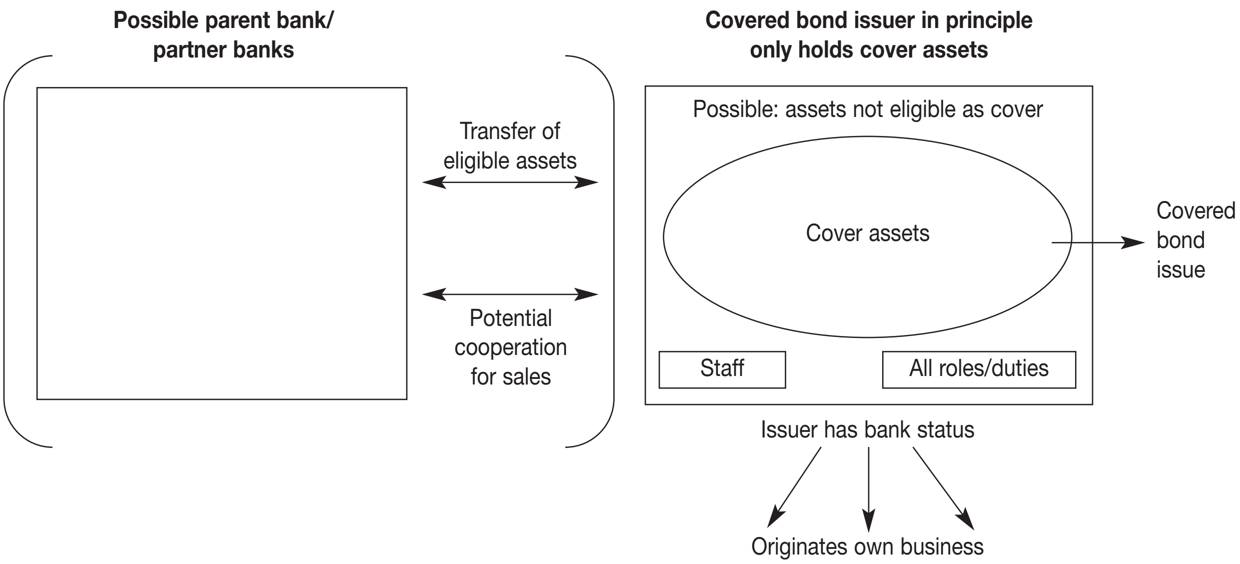


Table 3. Advantages and disadvantages of a specialist bank with outsourced administration

Advantages	Disadvantages
• Specialization on core business • Employees are risk aware • Low costs due to specialization of work flows • Easy to supervise • Issuer can decide which assets are included in the cover pool – therefore own asset/liability management	• Generation of business, inclusion in overall group, parent bank strategy • Problems with income generation ("resort to risk?")

14 Source: Gjede, Torben/Blume-Jensen, Lars/Pedersen, Mette-Saaby: Denmark; in: European Mortgage Federation: Mortgage Banks and Mortgage Bond in Europe, 4. A. Brussels 2003, p. 67 - 78

15 Source: Stöcker, Otmar:
– Das neue Hypothekenbankgesetz in Polen; Der Langfristige Kredit 1997, p. 650 – 655
– Die Novelle des Hypothekenbankgesetzes in Polen; Immobilie & Finanzierung 2002, p. 575 - 577

16 Source: Neubauer, Peter/Stöcker, Otmar: Neues Hypothekenbankgesetz in Ungarn; Der langfristige Kredit 1997, p. 483 - 485

17 Source: Stöcker, Otmar: Das neue Hypothekenbankgesetz in Luxemburg; Der langfristige Kredit 1997, p. 780 - 782

4. Universal Bank with Qualified Covered Bond License [FR2]

This is the structure used today in Latvia[18] and Russia[19]. It also became the statutory model in Germany[20] on July 19, 2005. Corresponding legislation is also being prepared in Slovenia. This model is based on the universal bank principle. Each bank wishing to issue covered bonds must qualify to do so and fulfill certain requirements. Whereas model 1 describes specialized banks, this model also refers to universal banks which are entitled to be granted a license for the issuance of covered mortgage bonds.

Illustration 5: Universal bank with qualified covered bond license

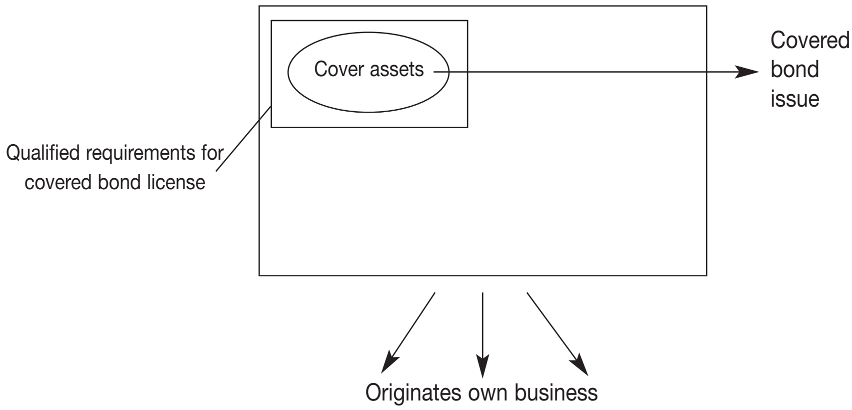


Table 4. Advantages and disadvantages of a specialist bank with qualified covered bond license

Advantages	Disadvantages
• No need to establish new, specialized banks; open to all lenders • Issuance right limited to a few stable issuers • May kick off higher volumes of standardized mortgages • May lead to lower prices for mortgage loans since more banks can stick to this funding instrument. Supply of funds increase.	• Higher risk at beginning until the necessary covered bond expertise has been developed at the universal banks • Difficult to avoid “opportunistic issues” • Hard to create a joint commitment on the part of the issuers for covered bonds and their further development[21] • May disadvantage existing holders at the start of covered bond issues (insolvency law: “cherry picking” in favor of the cover funds) • The less covered bond issuers are legally specialised, the more and detailed regulations their covered bonds need in order to achieve clear segregation and bankruptcy remoteness and to convince capital markets of it

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[18] Source: Stöcker, Otmar: Neues Gesetz über Hypothekenpfandbriefe in Lettland; Der langfristige Kredit 2000, p. 55 f.
Lassen, Tim: Änderungen im lettischen Hypothekenpfandbriefgesetz; Immobilie und Finanzierung 2004, p. 189 - 191

[19] Source: Dëmushkina, Yekatarina:
– Opredeleniye pravogo statusa ipotecnoy cennoy bumagi; Rynok cennykh bumag (RCB), No 24 (255) 2003, p. 32 – 39
– Konceptual'nye pochody k opredeleniju pravogo statusa ipotecnoy cennoy bumagi; RCB No 1-2 (256 – 257) 2004, p. 67 - 72
Lassen, Tim: Wiedereinführung Pfandbrief-ähnlicher Wertpapiere in Russland; Immobilie und Finanzierung 2004, p. 120 – 124
No license is required in Russia, but an issuer permit linked to central bank requirements is needed for each issue.

[20] Representatively: Hagen, Louis: A new Era for the Pfandbrief; in: Association of German Mortgage Banks: Der Pfandbrief; 9th ed. Berlin 2004, p. 12 - 18

[21] One suitable instrument for creating this type of commitment between non-specialist banks is a joint lobby group. This lobby group would serve as the catalyst for the further development of the covered bond market and legislation as well as as a joint platform for discussions between the issuers and other market players (eg rating agencies) and a centralized representative body in dealings with the regulatory authorities and legislator.

Examples of such groups are the Association of German Pfandbrief Banks (www.pfandbrief.de) which represents all German Pfandbrief issuers and the establishment of a specialist association of mortgage securities issuers planned by the Moscow Mortgage Agency, Delta Credit and Gorodskoj Ipotetetschnyj Bank.

Other specialist assocations in the mortgage financing sector in Europe are the Association of Danish Mortgage Banks (www.realkreditraadet.dk), the Mortgage Credit Foundation in Poland (www.fukrehip.pl), the Association of Hungarian Mortgage Banks (www.mortgagebank.hu), the Ukrainian National Mortgage Association (www.unia.com.ua) and at European level, the European Mortgage Federation (www.hypo.org) and under its auspices the specialist lobby group for covered bonds, the European Covered Bond Council (http://ecbc.hypo.org).

5. Issue Permit for all Banks without Licensing or Licenses without Requirements

Under this model, all banks can issue covered bonds without the issuance right being linked to any requirements. This is the case in Spain[22], the Czech Republic, Lithuania[23] and Bulgaria[24]. A license is necessary to issue covered bonds in Slovakia, but this is awarded upon request without the need to fulfill any requirements.

Illustration 6. Structure of a universal bank that issues covered bonds without the need for a license

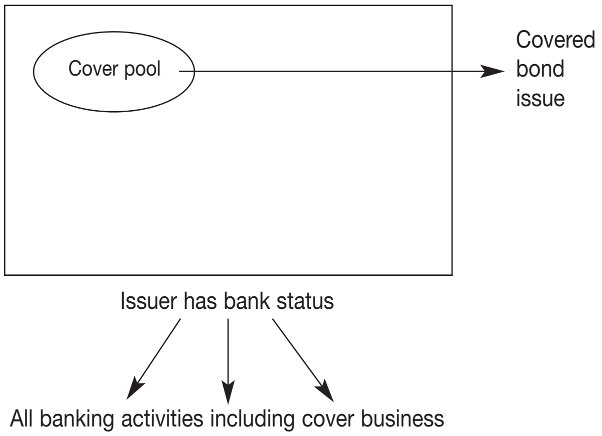

Table 5. Advantages and disadvantages of a universal bank without a covered bond license

Advantages	Disadvantages
• Large volume of outstanding covered bonds quickly built up • A large number of issues • No time-intensive establishment of specialist banks	• No "covered bond" specialization by issuers • Opportunistic issues • No, or problematic, development of a covered bond market, low level of interest in further development of the covered bond as an instrument. The banks are not linked to it, they don't have to do any effort to obtain any license. If they have some eligible assets, they can issue covered bonds – or not do it. • No, or problematic, development of a joint lobby by covered bond issuers and its further development (commitment). Commitment can not develop, if the banks are not linked to the product. • May disadvantage existing holders at the start of covered bond issues (insolvency law: "cherry picking" in favor of the cover funds) • In some cases security for covered bonds achieved by high level of excess cover (e.g. Spain: 11% for mortgage covered bonds; 31% for public covered bonds) • Ring fencing difficult: ratio of covered bond creditors to unsecured creditors (e.g. depositors) • The less covered bond issuers are legally specialised, the more and detailed regulations their covered bonds need in order to achieve clear segregation and bankruptcy remoteness and to convince capital markets of it

[22] Source: Nasarre Aznar, Sergio: La garantía de los valores hipotecarios; Madrid – Barcelona 2003

[23] Source: Lassen, Tim: Neues Pfandbriefgesetz in Litauen; Immobilie und Finanzierung 2005, p. 91 - 93

[24] Source: Lassen, Tim: Hypothekenobligationen in Bulgarien; Immobilien & Finanzierung 2004, p. 542 - 545

8. Summary and Policy Issues

There is no unequivocal answer to the question of whether or not specialization is necessary. To a large extent it depends on the structures already in place, market conditions and the relevant objectives. In a market dominated by strong universal banks it will be rather difficult to introduce specialized banks. If the banking sector is in an early stage of development, without dominating banks and the mortgage sector is starting to develop, it will be easier to implement specialized institutions as a link between mortgage market and capital markets.

If the legislator wishes to make a clear decision regarding the necessary degree of specialization, then the following policy issues should be clarified first:

a. Supervision
- Efficiency and intensity of supervision
- LTV limits for funding through covered bonds
- Security through institutional barriers or through over-collateralisation

b. Risk Management
- Responsibility for risk management and asset/liability management
- Risk awareness on the part of the issuer
- Issuer free to decide which assets it includes in the cover pool?
- Issuer to generate assets itself or function purely as a funding vehicle?
- Dependency of specialist bank on parent bank
- Question of priority for issuer's creditors
- "Ring fencing": Relation between covered bond creditors to unsecured creditors (eg depositors)
- Issuer's other creditors may be disadvantaged by the inclusion of the covered bond issue (depositors, debentures with pari-passu or negative pledge clauses)

d. Market and Sustainability
- Product diversification of the issuer
- Avoidance of opportunistic issues – need for sustainability of issues
- Issuers committed to establishing and developing a covered bond market

e. Profitability
- Cost of establishing a specialized issuer
- Diversification of earnings
- Operational costs of originator and issuer
- Volume of business eligible as cover in national market

II. Introduction of the New Pfandbrief Act in Germany

Specialization offers certain advantages to issuers and above all to Pfandbrief investors, including, in particular, specialization of work flows (and the associated higher level of quality), ring fencing and security in the event of insolvency, whereby creditors are protected from third party access to the cover pool (e.g. by depositors or other creditors).

Nevertheless – as shown above – the introduction of non-specialist institutions for mortgage lending and covered bond issues is often difficult due to political reasons or market structures.

Other precautions therefore have to be taken to achieve the quality assurance effects of the specialist bank principle, namely

- the joint commitment of the mortgage banks to the quality of the Pfandbrief, in particular through voluntary measures and the further development of the legal framework (Pfandbrief commitment),
- a high degree of homogeneity of the issuers as a requirement for a transparent and liquid market, and
- enhancing the security of the Pfandbrief.

Special statutory regulations on quality assurance and detailed provisions to ensure the preferential right in the case of insolvency of Pfandbrief holders are essential, if these aims are to be achieved within a universal bank system. The new German Pfandbrief Act, which came into force on July 19, 2005, is an example of these measures as outlined below.

Another decisive point for securing investors is the regulation on the preferential right in the event of insolvency (see 2 below).

Illustration 7: Difference between Mortgage Bank Act and new Pfandbrief Act

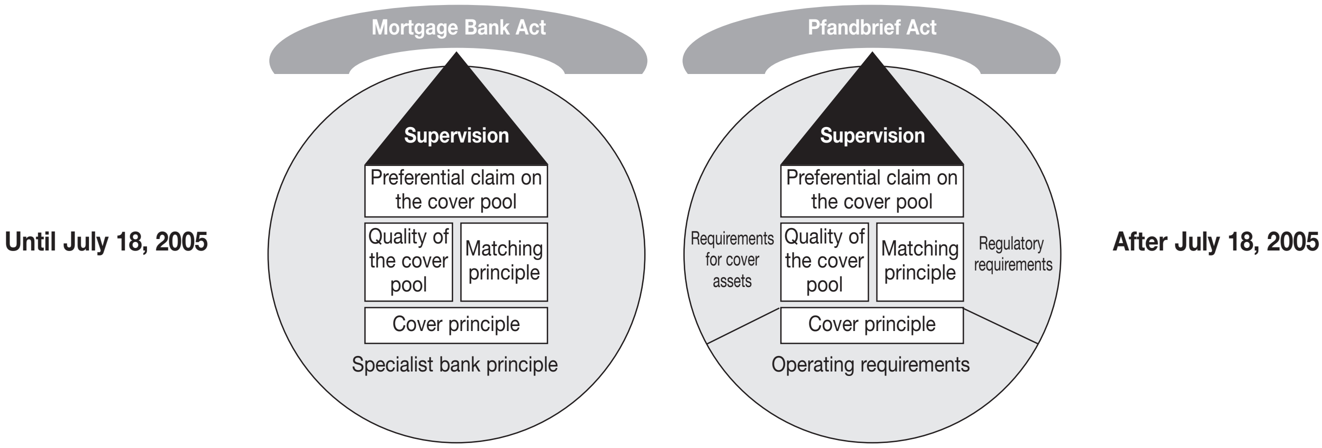

Illustration 8: Structure of the Pfandbrief Act

Structure of the Pfandbrief Act

Regulatory requirements
- Specific licensing for Pfandbriefe under certain circumstances
- Sanctions imposed by BaFin

Operating requirements
- Sustained Pfandbriefe issues
- Professional risk management
- Improved transparency
- Expertise of managers

Requirements for cover assets
- Claims on public financial institutions without state guarantees not eligible as cover
- Specification of LTV calculation provisions

Quality assurance measures

- Cover principle
- Matching principle
- Preferential right of Pfandbrief creditor in the event of insolvency
- Statutory surplus cover of 2% (incl. stress scenarios)
- High quality requirements for cover pool
  – conservative valuation
  – 60% LTV
- Special statutory supervision (BaFin)
- Independent trustees
- Preferential right of Pfandbrief creditor in the event of insolvency
- Clear contingency plan in the event of insolvency; administrator

Policies in Mortgage Bank Act

1. Quality Assurance Measures

a. Regulatory Requirements

- Requirement for a special Pfandbrief license

Not all German financial institutions automatically have the right to issue Pfandbriefe. Those institutions wishing to issue Pfandbriefe have to apply to the German Federal Financial Supervisory Authority (BaFin[25]) for the relevant license. This license may only be granted, if the institution complies with statutory requirements including a minimum tier 1 capital of €25 million, a business plan showing that the financial institution can operate its Pfandbrief business on a regular and sustained basis and that the necessary organizational structure is in place. In addition, the organizational structure and resources of the financial institution must take appropriate account of future Pfandbrief issues and the associated lending activities (real estate, public finance and/or shipping finance).

If these requirements are fulfilled the license will be granted. No permits are required from BaFin for individual issues.

- Express regulation on particular supervision of all requirements under the new Act

A key feature of the security of the German Pfandbriefe is the particular supervision by BaFin in addition to general banking supervision to ensure strict compliance with the statutory requirements. This is highlighted once again and regulated in even more detail in the Pfandbrief Act whereby BaFin is in future obliged to check the cover pool every two years as a rule.

- BaFin is authorized to transfer the cover pool and Pfandbriefe to another Pfandbrief issuer.

Previously, the cover pool could only be transferred in the event of the issuer becoming insolvent. The Pfandbrief Act allows BaFin to additionally revoke the Pfandbrief license, if the Pfandbrief bank no longer complies with the license requirements or has not issued any Pfandbriefe for two years and does not intend to do so within the next six months. If the license is revoked or expires, BaFin

[25] www.bafin.de, in Germany the supervision of banks, insurance companies and the securities markets is carried out by BaFin – the German Federal Financial Supervisory Authority.

can apply to the courts to appoint an cover administrator, whose rights are based on the regulations for a cover administrators in the event of the issuer's insolvency.

b. Operating Requirements

The operating requirements for Pfandbrief issuers replace the specialist bank principle, that was the mechanism regulating the financial institution as a whole. Consequently, only the management of the cover pool is subject to specific requirements, as this is the guarantee that the claims of Pfandbrief holders can be settled in the event of the issuer becoming insolvent.

- Professional risk management of cover pool

One precondition is that the Pfandbrief bank has suitable risk management systems to actively manage credit risk, cluster risk, market risk and liquidity risks relating to the cover pool. This also ensures that the issuer has to operate its Pfandbrief business in a sustained and non-opportunistic manner if it wants to amortize the necessary investment.

- Evidence of expertise in Pfandbrief issues and cover transactions

The Act requires that Pfandbrief banks possess specific expertise in the business fields in which the cover pool is generated, as well as in the management of specific risks. This requirement refers not only to systems but also to the employees of the issuer.

- Stricter transparency regulations especially regarding disclosure of the cover pool

The new transparency regulations under the Pfandbrief Act are based on the requirements of rating agencies and analysts of those Pfandbrief issuers which already have had to fulfill the requirements of the ratings agencies. This enables investors to judge the quality of the cover pool for themselves in terms of credit quality, regional diversification and volume. This leads to a disciplined approach which enhances the prescribed professional risk management.

c. Cover Asset Requirements

- Mortgage lending value calculation

The regulations governing the mortgage lending value calculation have been revised and clarified. Care has been taken to ensure that these regulations comply with today's accepted standards.

- State liability

It is now clear in the regulations that being a public sector institution is not sufficient on its own to make the assets of a public Pfandbrief eligible as cover and state liability is required instead.

2. Preferential Right for Covered Bond Creditors in the Event of Insolvency

One of the fundamental features of the covered bond is its preferential right in the event of the issuer becoming insolvent. The covered bond creditors have a prior right on the cover assets included in the cover pool.

a. European Legal Provisions

A preferential right in the event of insolvency is also stipulated in Article 22 (4) of the UCITS directive, which regulates the easing of supervisory requirements in the financial industry and sets a minimum standard for covered bonds in the EU for investors.

According to Article 22 (4), the cover assets must be specified as prior ranking by law for repayments of capital and interest in the event of a loss of the issuer. There must be no direct relationship between the covered debentures, which the financial institution issues and reports on the liabilities side of the balance sheet, and the cover assets, as long as the financial institution operates. Only if the issuer becomes insolvent does the true legal nature of the covered bonds (Pfandbriefe) come to light: the covered bond holder has a preferential right to satisfaction of his claim in the event of insolvency or a preferential lien with a comparable financial outcome. Creditors other than the covered bond holder may not enforce their claims on the cover pool. Only the covered bond creditors are entitled to a lien on the cover assets. Capital and interest must be serviced from the cover assets without them becoming part of the general bankrupt estate.[26]

However, the UCITS directive does not specify how the preferential right in the event of insolvency is to be structured.

b. Policy issues to be regulated

In principle, the less a covered bond issuer is required to specialize by law, the more precise the regulations must be to ensure a separation of the cover pool and bankruptcy remoteness, as well as timely payment of the covered bonds.

This preferential right is secured in different ways in the various covered bond systems in Europe.[27] Internationally, high demands are placed on the bankruptcy remoteness of covered bonds as complied with by new legislation in Ireland, France, Poland, Germany and most recently Russia.

Key points in today's European debate are:

- In case of insolvency of the issuer, the cover pool is managed by a court appointed administrator, as separate as possible from the insolvency administrator of the general insolvent assets of the issuer.

[26] Source: Bellinger, Dieter: Commentary on Art. 22 (4) of the UCITS-directive; in: European Mortgage Federation (publ.): Mortgage Banks and Mortgage Bonds in Europe; 3rd ed. Baden-Baden 2001; Point 4.13.2

[27] See the detailed questionnaire and the answers to Austria, Germany, Italy and Lithuania: www.pfandbrief.de – Pfandbrief – Covered bond legislation – Central European covered bond conferences – IX. Central European covered bond conference, Budapest 2005 – First Panel (Moderation: Dr. Otmar Stöcker)

- The management costs are financed by the surplus cover. In the event of the covered bond issuer becoming insolvent, the surplus cover must not be surrendered immediately.

- The provision of the option of transferring the assets entered in the mortgage register to another bank together with the covered bonds liabilities.

- Especially, the timely payment of the covered bonds has to be ensured.

The aim of a covered bond regulation is to secure the investors from any default of covered bonds. One possibility is to specialise the issuers on secure types of businesses like mortgage lending – but like eg the French model shows, this can be done in a way that leads to a type of a mixed bank – but on the other hand with a very clear structure in case of bankruptcy.

The main discussion today therefore should no longer be about a question of specialization (that can't be achieved due to many political or economic reasons), but about the way to secure investors as far as possible from the default of the issuer – by allowing issuance only to banks fulfilling special requirements and by detailed regulation of the preference right in case of bankruptcy.