

The Renaissance of the "Pfandbriefe" in Europe

by Dr. Otmar M. Stöcker

Between July 1995 and October 2000, nine new laws on "Pfandbriefe" (mortgage bonds)¹ and mortgage banks came into force in Europe. This article discusses the essential content of these laws, and some of their basic trends.²

The Pfandbriefe has been experiencing a renaissance in Europe in recent years. Just 10 years ago, the large number of small issues meant it was considered unattractive (i.e., not liquid) even in Germany. The Pfandbriefe revival is not only in Germany but also in other European countries, demonstrated not only by more frequent issues but, above all, by greater issue volumes.

The growing support for the Pfandbriefe is most clearly manifested in the fact that a number of European countries have adopted new laws on Pfandbriefe and mortgage banks. In some countries, individual regulations have been improved, while in others the entire mortgage bank and Pfandbriefe legislation has been replaced or created. The last few years have seen profound debates on principles to ascertain the need for, and the spirit of, the new proposals, par-

ticularly in those states that have established such a regulatory framework for the first time.

CENTRAL AND EASTERN EUROPE

At the start of the 1990s, the central and eastern European transition countries increasingly turned their attention to creating new structures to finance home building on a market basis, in order to tackle the politically pressing question of providing the population with enough housing of the very latest standard. The discussions focused on how to refinance (fund) these property loans.

In the search for possible solutions and funding models, the current situation in Europe was taken into account, as well as the experience of other countries and the historic roots of individual country's own traditions.

Long discussions were held regarding the question of whether the first legal regulations should help to introduce the European Pfandbriefe-system or the mortgage-backed securities model of the United States. In the end, all legislators in central and eastern Europe decided in favor of the Pfandbriefe and against an MBS system. One reason was existing mortgage law does not allow the

easy transfer of mortgage loans. Another was a banking philosophy that did not want to encourage the sale of high quality assets. On the one hand, nobody wanted to hinder MBS; on the other, many feared that the establishment of two different funding systems at the same time would not work, because both could not get sufficient volume and liquidity in the market. In addition, nobody wanted to do all the legislative work to introduce two new funding systems, or explain two similar instruments and systems to members of parliament.

EUROPEAN UNION STATES

The starting point in the E.U. states was, and is, quite different. All of these states have long-established, functioning structures for mortgage loans and their refinancing. There are also various kinds of mortgage bank and Pfandbriefe systems. On first sight, therefore, there would appear to be no need for a debate on principles.

However, capital market financing specialists have thought long and hard over a number of years about the impact of the euro on their respective sources of refinancing. The national currency is no longer an investment criterion for investors. So for capital market investors, especially foreign investors, security and liquidity aspects will take center

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stage. The banks have asked themselves whether their securities can compete with the German Pfandbriefe, the success of which they have been following on their screens on a daily basis for several years. Once the groundwork was complete, it was not long before conclusions were drawn. New laws on Pfandbriefe and mortgage banks were created, or existing laws³ improved.

At the same time, asset-backed securities (ABS) and MBS are used more and more in E.U. countries. Some legislation provides special regulations (e.g., France, Spain, Belgium and Italy), whereas in other countries ABS and MBS constructions have to be based on general civil law provisions. Until recently, Pfandbriefe and ABS/MBS were regarded as strictly competitive and contradictory. Today they are used as complementary financial products. For example, German mortgage banks were the first to use MBS in order to sell those parts of German mortgage loans which they are not able to fund via Pfandbriefe.⁴ French mortgage banks are allowed to use MBS as cover assets for Pfandbriefe. In Spain, Pfandbriefe are collected in special purpose vehicles (SPVs) to collateralize MBS issues.

All these new techniques tend to conserve equity and spread and reduce risks in order to achieve a bigger part of the capital market and to conform with the demands of rating agencies, analysts and investors.

SECURITY BENCHMARKS

Whereas for the reform countries the German Pfandbriefe in its usual form frequently serves as a benchmark, the E.U. states are concentrating on the jumbo Pfandbriefe as the appropriate security benchmark. Today the main criteria for a German jumbo Pfandbriefe are the following⁵:

- Minimum volume of 500 million euros.

- Straight bond structure.
- At least three market makers with fixed bid/offer prices.

These criteria, primarily developed since 1995, have facilitated the development of a huge liquid market of German Pfandbriefe.

LEGAL BENCHMARKS

In western, central and eastern Europe, the fulfillment of all E.U. provisions is clearly a central concern. In the absence of a special directive for the Pfandbriefe, the criteria of Article 22 Paragraph 4 of the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS) (also referred to as the Investment Directive) are generally taken as guidance, being seen as the minimum standard for the Pfandbriefe in Europe, not least because these criteria have been incorporated in six other directives as well as in the European Central Bank's (ECB) Lombard eligibility list. In a number of countries, only the existence of these E.U. regulations could persuade the national legislative bodies to grant preferential rights in bankruptcy proceedings for Pfandbriefe holders.

SPECIALIZED BANK PRINCIPLE AND OUTSOURCING

In all countries, in the West and in the East, that considered creating new regulations for Pfandbriefe, the issue of specialized banking has been the subject of very intense debate. In particular, there has been much discussion as to whether the law should require Pfandbriefe issuers to be specialized banking institutions or whether universal banks should be allowed to issue such securities.

On the one hand, there is the belief that clear structures are required as regards insolvency laws, in order that the cover pools

can be clearly allocated to the Pfandbriefe creditors—something that can more easily be achieved if there is a specialized bank principle. Both for reasons of investor protection and with a view to commercial efficiency, the tendency is to create a manageable and transparent organization and business structure. This is seen to have clear benefits when it comes to achieving the necessary trust among capital investors in the steadiness of the Pfandbriefe issuers and, by extension, the security of the "Pfandbriefe" themselves.

On the other hand, particularly in countries considered to be "overbanked"—and this can be said of almost all European countries—there is a reluctance to prescribe by law that new financial institutions have to be created for an area as important as real estate financing.

It therefore seems reasonable to attempt to combine the benefits of the specialized bank principle as regards transparency and building trust among capital investors with the aspects of efficiency and group integration.

- One of the options is the Finnish model of a mortgage bank. According to the legal provisions, it seems to be very similar to the German mortgage bank system. But in practice, the bank's business is carried out almost entirely by group companies, so that very few staff are required. They check on whether the loans that are offered from other companies are of sufficient quality to serve as cover for their Pfandbriefe. Only then do they buy them.
- The French mortgage bank system goes even further. This system is organized in such a way that it is practically impossible to take on staff. Here, the Pfandbriefe issuer becomes a kind of special purpose vehicle within the banking group.

According to current standards of German law on banking supervision, neither the French nor, probably, the Finnish model would be allowed.⁶ From the German supervisor's point of view, it is essential that every bank has its own management and staff with sufficient know-how to do all necessary work for risk controlling, credit decisions and real estate valuation (or at least checking of valuations of external experts).

It is somewhat surprising that this model of a quasi-virtual mortgage bank is not considered problematic by either analysts or the rating agencies. (Most of the reports comparing the new legislation for mortgage banks in Europe do not even mention this difference.) This may be because of its conceptual proximity to the U.S. MBS, the structure of which is very familiar and for which there are long-standing, tried and tested procedures at hand when it comes to carrying out reviews. Whether their Pfandbriefe are able to achieve long-term success on the capital market and whether they can truly compete with the German Pfandbriefe remains to be seen.

CONTENT OF THE NEW LAWS

All new laws fulfill the criteria of the European minimum standard for Pfandbriefe, as set out in particular in Article 22 Paragraph 4 of the Investment Directive (see table on pages 34 and 35); only the Bulgarian law leaves some unanswered questions in this respect.

Slovakia, Poland, Luxembourg, France and Finland are introducing both the mortgage Pfandbriefe and the public Pfandbriefe; the Czech Republic, Hungary, Latvia and Bulgaria, however, only have regulated the mortgage Pfandbriefe.

The majority of the new laws require a special mortgage lending value⁷, to be

calculated prudently, and in compliance with a limit of 60% (France: 60%–80 %) of this value for the refinancing of mortgage loans by the issue of mortgage Pfandbriefe. The Czech Republic and Latvia, on the other hand, are looking to a limit of 70%, or 60% of the market value, and Bulgaria ranges between 60%–80 % of the market value.

Apart from the Czech, Latvian, Finnish and Bulgarian provisions, all the new laws provide for a trustee, whose job it is to check the Pfandbriefe cover assets to be entered in a cover register. This cover contains the assets which are reserved for the Pfandbriefe holders in case of a bankruptcy of the issuing mortgage bank.

All the laws provide for a statutory preferential right in bankruptcy proceedings for Pfandbriefe creditors and specialized banking supervision. Only the Bulgarian law makes no such express provision on supervision.

These various provisions are listed individually in the table on pages 34 and 35.

DRAFT BILLS

Even though nine new laws on mortgage banks and Pfandbriefe have already been created in recent years, the development in Europe is not yet complete.

Among the E.U. states, Ireland merits particular mention, because it has already fully formulated a bill. Working groups in Belgium and Italy are preparing such bills.

As for the transition countries, concrete draft bills exist in Estonia and Russia. The groundwork is currently being undertaken for bills in Belarus and Slovenia. In the future there will be fewer and fewer states without Pfandbriefe regulations.

LICENSES AND ISSUES

- In the Czech Republic, nine banks have already obtained the license in principle to issue Pfandbriefe. Between July 1996 and the end of 2000, there were 20 Pfandbriefe issues, with a total volume equivalent to around 627.5 million euros.
- In Slovakia, five banks have now been awarded a Pfandbriefe license and at the end of 2000, there were four issues of Slovakian Pfandbriefe with a total volume equivalent to 12.9 million euros outstanding.
- In Hungary, two mortgage banks are engaged in the mortgage business. By the end of 2000, the state-owned Hungarian mortgage bank had put Hungarian Pfandbriefe with a total volume equivalent to around 23.2 million euros on the market, in five issues.
- In Luxembourg, three mortgage banks have been established to date; at the end of 2000, these three together had issued "Pfandbriefe" (Lettres de Gage) of a volume of 3.5 billion euros.
- The two Pfandbriefe issues by the two mortgage banks in Poland that were already active had a combined volume equivalent to 4.9 million euros at the end of 2000. A third mortgage bank license has been awarded. Other licensing procedures are still ongoing.
- What is at present the only mortgage bank in Latvia has (as at the end of 2000) effected four Pfandbriefe issues with a total volume equivalent to 6.6 million euros.
- In France, there are currently two mortgage banks operating in accordance with

the new law, whose total issue volume of French "Obligations Foncières" totalled 16.5 billion euros at the end of 2000. Preparations are currently underway to establish another mortgage bank.

- On the basis of the new mortgage bank law, two mortgage banks have been established to date in Finland. No Finnish Pfandbriefe had been issued through end of 2000.
- Although no special Pfandbriefe license is required, as at the end of 2000, no Pfandbriefe had been issued in Bulgaria.

**TERMINOLOGY REGARDING
"PFANDBRIEFE" IS BECOMING
MORE IMPORTANT**

Although in this brief account, the term Pfandbriefe is used for all new laws, this does not mean that it is assumed that all European Pfandbriefe are equivalent to the German Pfandbriefe. According to §5a of the German mortgage bank law, the term "Pfandbriefe" is protected by law and may, in principle, only be used for bonds of German mortgage banks. In accordance with European law, this provision is to be interpreted in such a way that banks with a registered headquarter in another E.U. member state may also use the term Pfandbriefe if their bonds are equivalent to the German Pfandbriefe. However, the criteria by which this equivalence should be judged have yet to be determined. There is general agreement that the criteria set out in Article 22 Paragraph 4 of the Investment Directive are not sufficient.

This subject, which for a long time has been rather theoretical, has in practice already become current—e.g., when foreign mortgage banks want to offer their products in Germany using the German word "Pfandbriefe." This will be even more the case if the non-German issuers of Pfandbriefe or securities similar to Pfandbriefe exploit the level

of awareness of the German Pfandbriefe with the intention of marketing their securities to investors of German Pfandbriefe.

OUTLOOK

The large number of new laws and draft bills in Europe covering mortgage banks and Pfandbriefe clearly shows that, far from being passé, the Pfandbriefe is more modern than ever.

The most hotly contested issue in all countries is whether the law should require Pfandbriefe issuers to be specialized-banking institutions. In those E.U. states in which the German Pfandbriefe is viewed as a benchmark the new laws take this stance. From a legal perspective, it appears that the specialized bank principle is accepted throughout Europe.

Yet increasingly the question is being asked: What does this specialist bank principle mean for Pfandbriefe issuers? How specialized should a mortgage bank be? Is the French model of a quasi-virtual mortgage bank without staff, and thereby as a special form halfway between the European mortgage bank model and the U.S. MBS, the way of the future or is it the wrong track? This is the most pressing question to be addressed today throughout Europe in that sector.

NOTES

¹ The German Pfandbriefe and its issuers were explained by Arndt, Franz-Josef; *Housing Finance International*, March 1999, p. 14-24

² In this article, the German word "Pfandbriefe" is used to ensure that the term mortgage bond is not confused with the term mortgage-backed security (MBS). Mortgage bonds are typically straight debt issues of mortgage banks, whereas MBS are typically pass-through issues from bankruptcy re-

mote entities (e.g., trust, special purpose vehicles). See the article by Judith Hardt in this issue.

³ Most of these improvements concerned the regulations governing the preferential right of Pfandbriefe creditors in bankruptcy proceedings. Since the German provisions were supplemented in such a way as to accord the cover pools the character of special assets, legislators in Luxembourg and Finland have also supplemented their laws accordingly.

⁴ Specifically, only loans with loan-to-value ratios (LTV) less than 60% can go into the Pfandbriefe cover pool. Mortgage banks originate higher LTV loans and use MBS to fund the portion of the collateral pool with LTVs greater than 60%.

⁵ See homepage of VdH: www.hypverband.de—English Version—Pfandbriefe—Jumbo Pfandbriefe; Herges, Jumbo Pfandbriefe—relative value analysis, in: VdH, The Pfandbriefe—Facts and Figures 2000.

⁶ Cf. the remarks of the member of the Directorate of the Deutsche Bundesbank, Edgar Meister, repeated verbatim or in summary form (Handelsblatt dated June 11, 2000) on the announced Outsourcing Circular: "Although new communication technologies offer almost limitless possibilities for this, a purely virtual bank, which has handed over almost all functions to other companies, would not be reconcilable with our Supervisory law Central management tasks and decisions as a result of which banking risks could arise cannot be outsourced The Authority considers the complete outsourcing of an institution not to be permissible. It places tight restrictions on the outsourcing of control and audit functions."

⁷ Mortgage lending value is defined as the value of the property as determined by sur-

Table 1 New Laws on Mortgage Banks and "Pfandbriefe" in Europe

	Germany	Czech Republic	Slovak Republic	Hungary	Luxembourg
Regulations came into force on	1/1/1900	7/1/1995	3/1/1996	6/7/1997	12/19/1997
Principle of specialized banks	yes	limited mortgage bond licenses	limited mortgage bond licenses	yes	yes
Name protection	yes (Pfandbriefe)	yes (zástávní list)	yes (záložní list)	yes (jelzáloglevél)	yes (lettre de gage, Pfandbriefe, mortgage bonds)
Mortgage bonds can be used to refinance	mortgage and public-loans	mortgage loans	mortgage loans and public-sector loans secured by mortgages	mortgage loans and restricted public-sector loans	mortgage and public-sector loans
Cover register	yes	'independent evidence'	yes	yes	yes
Statutory preference in case of bankruptcy	yes	yes	yes	yes	yes
Regulations in respect of valuation	yes	no	yes	yes	yes
(Relative) lending limit for refinancing by mortgage bonds	60% of the mortgage lending value	70% of the market value	60% of the mortgage lending value	60% of the mortgage lending value	60% of the mortgage lending value
Absolute lending limit	generally no	no	no	generally no	generally no
Non-cover limit (volume above the relative lending limit)	20%	no	15%	no	no
Trustee	yes	no	yes	yes	yes
Substitute cover	yes	yes	yes	yes	yes
Substitute cover limit	10%	10%	10%	20%	20%
Public-sector bond	yes	no	yes	no	yes
Special ranking of cover mortgages	no	yes	yes	no	no
Special public supervision	yes	yes	yes	yes	yes
Art. 22(4) UCITS directive fulfilled	yes	yes	yes	yes	yes

Source: Association of German Mortgage Banks © Dr. Stöcker, VdH

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Poland	Latvia	France	Finland	Bulgaria
1/1/1998	9/29/1998	7/27/1999	1/1/2000	10/13/2000
yes	limited	yes, but no staff permitted	yes	no
yes (list zastawny)	yes (k i w l u z i w m e)	no (obligation foncière)	yes (kiinteistovakuudeliinen joukkovelkakiryeslaina, julkisyhteisöva-kuudellinen joukkovalkakiryeslaina)	yes (ПХФШ ^а ТИ облигация ипотечна obligacija)
mortgage and public-sector loans	mortgage loans	mortgage loans and public-sector loans secured by banks or insurance	mortgage and public-sector loans	mortgage loans
yes	yes	no	yes	yes
yes	yes	yes	yes	yes
yes	yes	yes	yes	yes
60% of the mortgage lending value	60% of the market value	60/80/100% of mortgage lending value/market value	60% of the mortgage lending value	60/80% of the market value
80% of the mortgage lending value	no	60/80/100% of mortgage lending value/market value	generally no	no
10%	no	no	1/6	no
yes	no	yes	no	generally no
yes	yes	yes	restricted with no regard to time	yes
10%	20%	20%	no	30%
yes	no	yes	yes	no
yes	no	no	no	no
yes	yes	yes	yes	??
yes	yes	yes	yes	??

EUROPE

veyors external or in-house, who are not involved in the banks' lending decisions, by a conservative and prudent assessment of the future marketability of the property, which takes into account the long-term sustainable aspects of the property, the normal and local

market conditions, and the current use and alternative appropriate uses of the property. Speculative elements shall not be considered. The mortgage lending value shall be documented in a transparent and clear manner. Sustainability requires that only the

permanent characteristics of the property and the yield, which any tenant could ensure by proper management, will be taken into account. Temporary peaks in market prices for property and rents may not influence the valuation.