

Development of the Intermediary Market in Germany

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1 The residential mortgage market in Germany

With more than one trillion Euro outstanding, Germany is the largest market for the residential mortgage business in Europe. More than 100 billion Euro of new business is originated annually. The residential market segment is not growing, however, as the homeownership rate is relatively small in comparison to other European countries and there is limited early repayment. The major reasons for the low homeownership share are extensive building costs and the state-aided flat building. High costs result from strict legal regulations concerning house building in Germany. Thus, over the past ten years, mortgage lending has remained stable at an amount of 100 billion Euro with a fluctuation rate of $\pm 20\%$ per annum which was mainly due to interest rate fluctuations as well as to the come and go of federal loan programmes for both owner-occupied and rented property.

Unlike other countries the retail banking business in Germany comprises the financing of both owner-occupied flats and small multifamily residences for letting purposes. In the nineties, the proportion of mortgage loans for letting purposes amounted to approximately 50%. Due to the high risk of high-value mortgages on letting property and the abolition of government aid, this market segment has presently declined to a 20% market share.

The central feature of the German market is the extensive standardisation of the

mortgage business. It is estimated that 98% of the market volume derives from annuity loans with a fixed interest rate of 10 years on average and fixed terms of repayment - considering that the prepayment risk does not play such a substantial role in Germany as it does in the United States. On the other hand, more and more lenders are trying to compete by granting an option for unscheduled loan repayment.

The tremendous stress of competition for one and the same product has brought about an efficient market place with consumer-friendly prices of 30 to 60 base points over the swap curve.

2 Sales and marketing in the residential mortgage sector

The German market for sales and marketing services is still dominated by banks (branches) and the "Bausparkassen".¹ Similar to Anglo-Saxon markets, the independent financial intermediaries are advancing. In the nineties, large financial intermediaries grew up and offered a wide range of financial products originating from the banking and insurance sector. Presently, the largest agencies acting as intermediaries are DVAG, AWD and MLP. They collect a commission volume of 300 to 700 million Euro annually. The small margins in the mortgage business however mean lower commissions for large financial sales organisations, so consequently mortgages as a product only played a small role for these organisations in the beginning (less

than 5% of the total commission volume). The main focus was directed towards provisioning products, predominantly life insurance policies.

Facing the breakthrough of the Internet by the end of the nineties, intermediaries began focusing on the mortgage business for the first time. From 1999 to 2003 the market segment of the online mortgage business listed an increase from 0.5 billion to 4 billion Euro per year in new business (see figure 1).

The severe competition among the online intermediaries has lessened and this market has become relatively stable today. The market leaders Dr. Klein & Co. and Interhyp annually arrange mortgage loans amounting to more than 1 billion Euro via online processing. With the help of small commissions and lean processes, Dr. Klein & Co. is focusing on experienced clients with only little consulting requirements, whereas Interhyp addresses clients with increased consulting requirements making equally increased sales and marketing efforts. Beside these two leading brokers, there is no other intermediary in Germany with more than 200 million Euro annual business volume generated via the Internet.

With the development of the online market place, the market segment changed to include personal consulting services. The comprehensive financial services and particularly MLP increased their intermediary volume and have also exceeded 1 billion Euro.

¹ [Ed.] Bausparkassen are specialised institutions providing contract savings products and associated loans. They also act as marketing agents for other financial intermediaries.

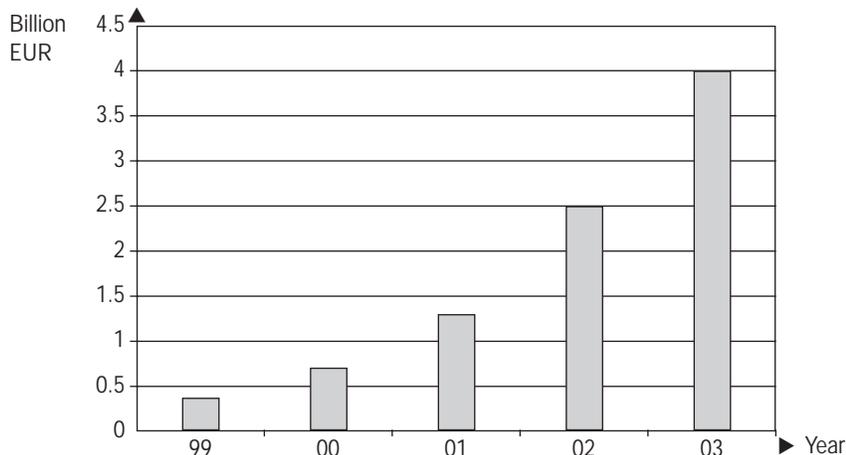


Fig. 1: Online market of residential mortgage business

Additionally, financial sales and marketing services have developed via franchising concepts focusing exclusively on mortgage consulting, closing financing transactions and arranging the respectively appropriate

lender. Freie Hypo is presently the market leader with an intermediary volume of more than 200 million Euro originated in nearly 60 regional offices with a growth of more than 100 % each year.

	Contractor	Nominal/Effective Interest
1	HypothekenBörse	4,69 / 4,79
2	MkiB GmbH	4,70 / 4,80
3	Dr. Klein & Co. AG	4,71 / 4,81
	BF.direkt	4,71 / 4,81
5	Baufi-Direkt	4,72 / 4,82
	Interhyp AG	4,74 / 4,82
7	Geld & Plan	4,73 / 4,83
8	Accedo AG	4,76 / 4,86
9	Creditweb	4,76 / 4,87
	Enderlein & Co.	4,76 / 4,87
	Haus & Geld	4,76 / 4,87
	Hypopool	4,76 / 4,87
	Financescout24	4,77 / 4,87
14	Competence	4,79 / 4,90
15	easyhyp	4,78 / 4,91
	ImmoBank direkt	4,80 / 4,91
17	BestHypo	4,81 / 4,92
	PlanetHome	4,83 / 4,92
19	Kredite-Direkt	4,85 / 4,96
20	Baufi 100	4,88 / 4,99

Fig. 2: Top intermediaries for a 150,000.00 EUR mortgage loan up to 60% LTV, 10 years fixed

(Source: www.vergleich.de Date: 12-03-03)

Another particularity of the German market is the fact that more and more banks themselves purely act as intermediaries (e.g. Citibank, SEB and the Volksbanken)². The selling of externally originated loan products through the branch offices of traditional banks is the result of the ongoing focussing on the core competence especially with marketing oriented banks. This trend is progressively supported by the strategic initiatives of the Genossenschaftsverband, the cooperative association, which arranges efficient centralised servicing, risk spreading and refinancing in specialised head offices for the still approximately remaining 1,500 regional cooperative banks (Volksbanken) and a similar, early stage effort for the savings banks (Sparkassen). The important regional diversification as it was formerly assumed is now taking the back seat to an intensive cost and efficiency discussion. Loan products are being practically standardised. The readiness to take the risk is often more obvious at the regional level due to a profound knowledge of the market. In these cases, at least the servicing activities will be centralised in the future.

The analysis of top interest rates for residential mortgages illustrates that the competition for the most favourable term is still ongoing (see figure 2). Even the best offers differ only by a few basis points. In the meantime electronic information platforms have been set up and allow comparison of offers in terms of quality and the intermediary's straightforwardness.

With market driven prices, only the most efficient business system will prevail. In former times an intermediary's essential core competence was based on marketing know-how and professional knowledge of the market place. Today the professional handling of processes and information technologies is additionally playing a decisive role to allow efficient cooperation with the top originator from all available for each customer.

² [Editor] Volksbanken or Genossenschaftsbanken are cooperative banks which have a significant market share in Germany. Sparkassen are saving banks owned by state and city governments with (collectively) the largest market share of mortgages.

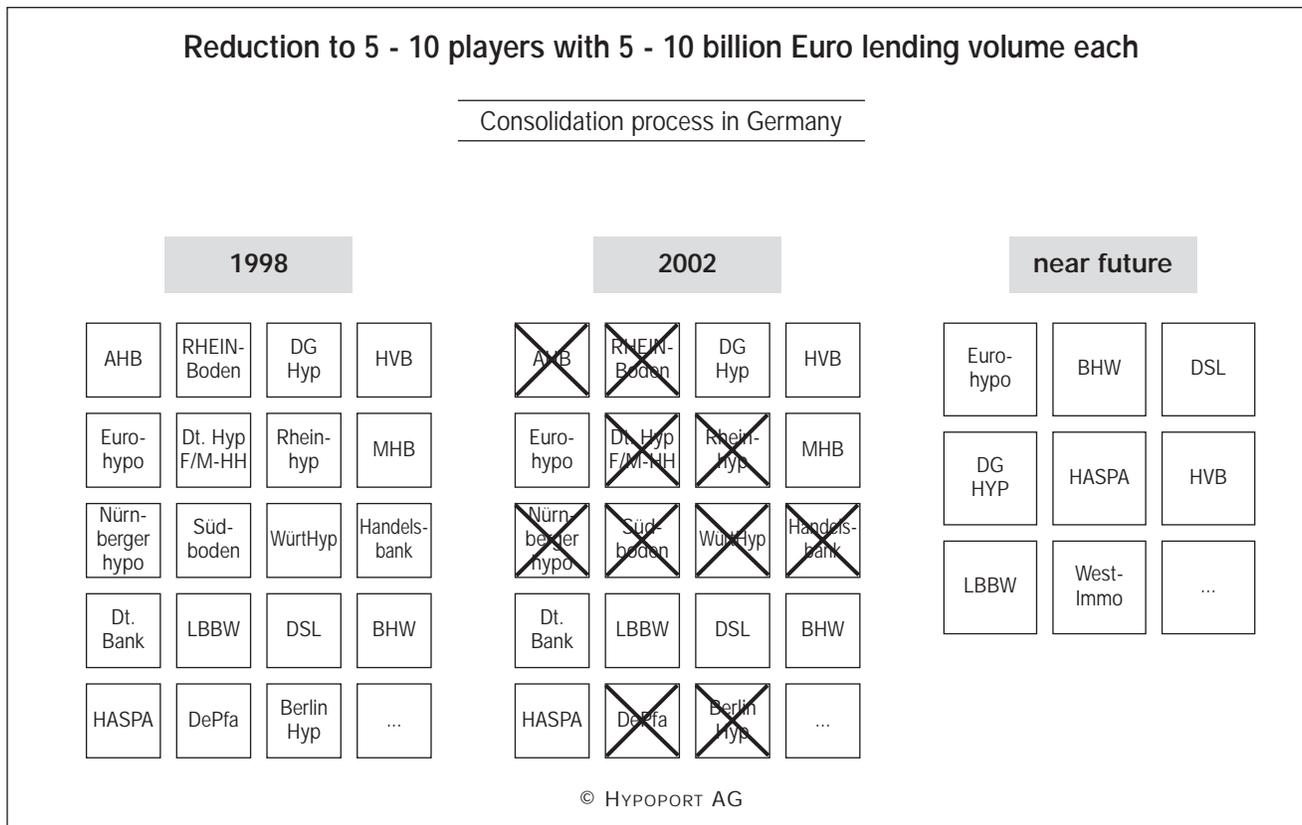


Fig. 3: Concentration on the German mortgage market

3 Development of originators and servicers in Germany

As a result of the German banks' profitability squeeze, specialisation was pushed along the entire value creation chain.

Many of the larger lenders (NürnbergHyp, Deutsche Hyp, Rheinhyp, BauBoden) disappeared from the market, others focused on their role as originator (DSL Bank, LBBW, WestImmo) or portfolio bank (DG Hyp, AHBR, Eurohypo). This consolidation has led to slightly increasing margins in Germany. Driven by economies of scale the consolidation process is still in full progress (see figure 3). Yet more than 2,000 banks advance mortgage loans in Germany. Many of them handle all administration and have the risks appear on their balance sheets. At present, the growth of large players is already progressing far more dynamically than that of the smaller ones. As a consequence, a market

concentration similar to market shares in the U.K. (the top ten are holding a market share of more than 80 %) is anticipated for Germany in approximately five to ten years.

Moreover, third party servicing specialists such as Kreditwerk, Hypotheken-Management, Stater and Prompter have been created. This business system, adopted from the Anglo-Saxon markets is only accepted very hesitantly. Outside their own organisations the servicers have only been able to win smaller customers so far. The reasons are complex. One example is the strict supervisory control which creates a relatively high overhead for servicers and as the case may be the outsourcing banks. IT systems to support multi-instance servicing initially have to be developed at great expense or will be subject to further development later on. These high initial costs preclude competitive prices of servicers.

Although staff reduction at banks in Germany has been remarkable, the banks are afraid of outsourcing the processing units entirely and try to gain efficiency with in-house departments instead.

Another important reason for the little success of independent servicers so far is the fact that close cooperation between the intermediary and servicer/originator is inevitable. A strict handling of credit enquiries by the servicer following the originator's strict guidelines has not proven well for cooperating. In fact, the large intermediaries have set up extensive packaging services for new business production in order to combine sales and marketing with servicing. For example, Dr. Klein & Co is annually processing more than 1 billion Euro of new business, including sales and marketing, calculation, valuation, scoring, documentation and data transfer to the lenders' IT systems.

4 Change of risk management, markets for refinancing and the establishment of securitisation transactions in Germany

Credit risk management systems were extended in Germany in recent years due to the upcoming requirements of Basel II. The rather pragmatic approach applied currently is applying analytical approaches on basis of current models. Due to a long handling time, the required data is not yet thoroughly available in the banks' IT systems.

Over the past four years the most important changes took place on banks' liability side. Traditionally, the German mortgage business was dominated by mortgage banks. They refinance through the advantageous "Pfandbrief" as defined by the Mortgage Bank Act (in total 150 to 200 billions p.a., approximately 66 % allocated to public loans and 33 % to mortgage loans). Under guidance of their association, German mortgage banks have managed to establish the Pfandbrief as an internationally accepted, secure and liquid refinancing vehicle by consistently making moderate changes to the Mortgage Bank Act. A few years ago, steadily growing tranches were issued (Jumbo and Global).

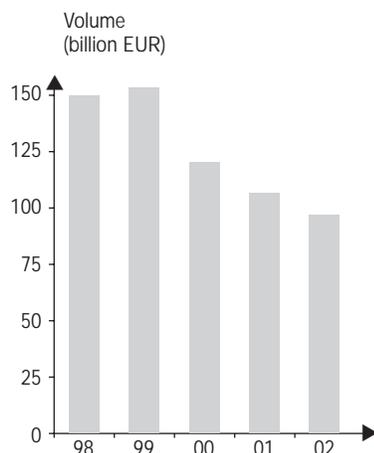
Nevertheless, there has been a spread increase in recent years from traditionally a few base points to nearly 20 base points at some banks. This was mainly driven by a changed risk assessment on the part of investors accompanied by lower ratings. These however actually referred to the uncollateralized securities of the bank - the Pfandbrief were always rated AAA. In the meantime spreads have reduced again, even if they still have not reached the former level. The considerable increase of credit risks caused by the reduced economic power in recent years has even resulted in a massive profit collapse for the German banking business. Mortgage specialists however did get off relatively lightly. Nevertheless, extensive cost reduction, restructuring and staff reduction projects have been launched. The more severe demands from rating agencies regarding underlying equity capital have exerted more pressure for increased profitability and a cutback of the credit portfolio for a rising equity ratio.

Banks and especially property financiers have responded with a strengthened portfolio trade and the securitisation of credit risks to achieve equity relief. Due to the legal position of Germany (banking

confidentiality, data security, and transfer costs of securities) synthetic transactions have almost exclusively been processed after the initial true sale transactions in the nineties. These allow issuers to very simply realise the aimed relief of equity capital. Altogether, the market has shown growth.

According to the supervisory commission, a bank achieves an equity capital relief of 80 % by purchasing a credit default swap (CDS) with an OECD bank. If the CDS counterpart is a state-guaranteed bank like the "Kreditanstalt für Wiederaufbau" (KfW), the bank will even obtain 100% equity relief. Against this background and with the help of the two securitisation programmes PROMISE and PROVIDE, the KfW has become a very strong player in the German securitisation market. Via credit default swaps banks are transferring their credit risks to the KfW which is then transferring these entirely to a Special Purpose Vehicle (SPV) issuing Mortgage Backed Securities. The KfW is subsequently not keeping any risks on the balance sheet - the only advantage being the 100 % equity relief for the bank. Since nearly all transactions are being handled via these programmes, they can be considered as the de facto standard for synthetic securitisation transactions.

Residential mortgage business (originated volume) in Germany



Source: DIW, European Securitization Forum

ABS/MBS (issued volume) in Germany

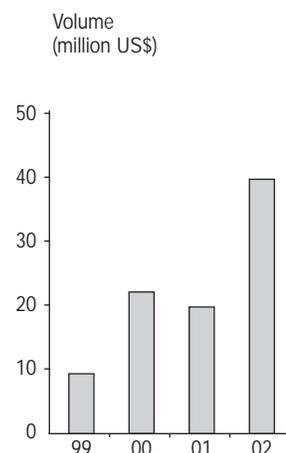


Fig. 4: Lending volume versus MBS/ABS issuance

Since October 2002, DG Hyp as the largest mortgage bank among three in the cooperative bank association has been helping the smaller cooperative banks to bundle their portfolios via the DG Hyp and to jointly place these on the market. The smaller cooperative banks do not have direct access to the capital market because of their small portfolio volumes.

In the year 2003, the KfW together with 13 German banks has initialised the development of a German true sale market. The aim is to mutually improve the legal framework, to establish standards for true sale transactions and to create a liquid market. The main focus is initially not targeted at mortgage loans but at receivables from small and medium-sized enterprises (SME) since these currently have the greatest difficulties to acquire loan capital.

Eurohypo is also trying to upgrade its true sale vehicle Opera Finance No. 1 PLC for commercial mortgages to a securitisation platform. The first transaction was processed in November 2003.

Hypoport AG is cooperating with nearly all housing industry associations in order to establish an alternative financing vehicle for housing companies. Via a special purpose vehicle obligations from housing companies are purchased, bridge financed and after closure of the loans and portfolio set-up they are placed as Mortgage Backed Securities on the capital market. Due to the traditionally low credit risk of the German housing industry, the major advantage is the establishment of a specialised asset class with low capital market spreads instead of mixing the housing companies' obligations with poorly rated assets.

One of Hypoport's core activities is to support the transaction processing with the help of an integrated software technology which allows the collection of relevant market information from the originator and to calculate fair capital market prices. The technology is integrated into existing portfolio-reporting and -rating tools as well as in a multi-language originator software for residential mortgages.

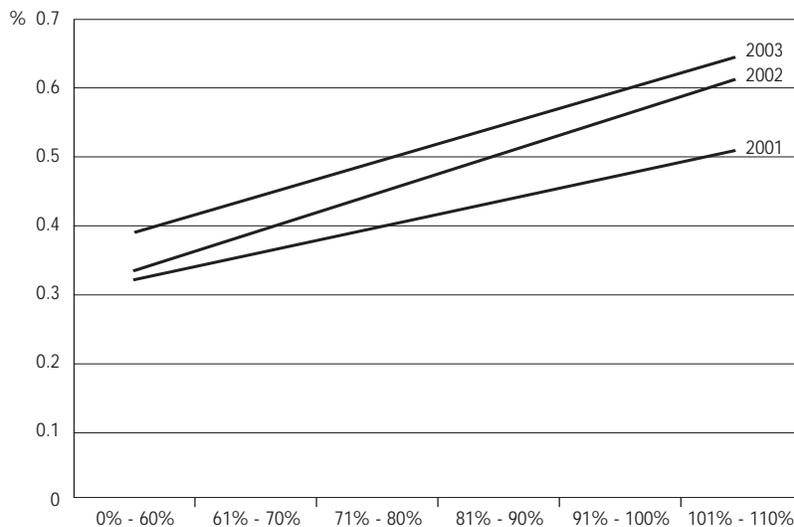


Fig. 5: Bank margins in % dependent on the loan to lending value 2001-2003 (Source: Europace IPD Ltd., Westport)

From the present community of innovative leaders there will be one to three intermediaries who will emerge from the highly fragmented competition of originators (savings banks and cooperative banks) and the capital market. Their core competences will consist in purchasing and bundling portfolios and in placing these on the capital market as a whole. Also on the capital market side this will lead to the standardisation of products and documentation. Factors for success will be a high-performance technology, know-how, market access and the integration into extensive originator software. Furthermore, European harmonisation will take place in the long term partially adjusting legal frameworks and standards in the securitisation process.

This development will additionally be driven by the abolition of the so called "Staatsgarantie", a state guarantee in the savings bank sector which will generate bank ratings far lower than their current AAA. From the investor's point of view a consolidation of the Pfandbrief and securitisation market will take place, major initiators being the analytical approach of the rating agencies as well as the development of Pfandbrief-like covered bond structures. The presently

heterogeneous securitisation structures will also be readjusted with the establishment of only a few intermediaries.

5 Description of exclusive intermediary market segments along the value chain

The consolidation process of the individual steps in the value chain is basically driven by prices. At the time of a weak residential mortgage market by the end of the nineties, a decline in spreads to less than 30 base points was experienced. The originators were primarily affected by the price decline since the intermediaries managed to keep their sales commission relatively unchanged. Though margins in Germany have increased by 10 basis points over the last two years (see figure 5), the quite low level still demands a high degree of efficiency of intermediaries and originators.

Apart from the internal rationalisation of processes primarily driven by the continuously extensive usage of electronic communication vehicles, the integration of direct neighbours within the value chain is becoming more and more important.

An integration process without corresponding standards for IT, processes

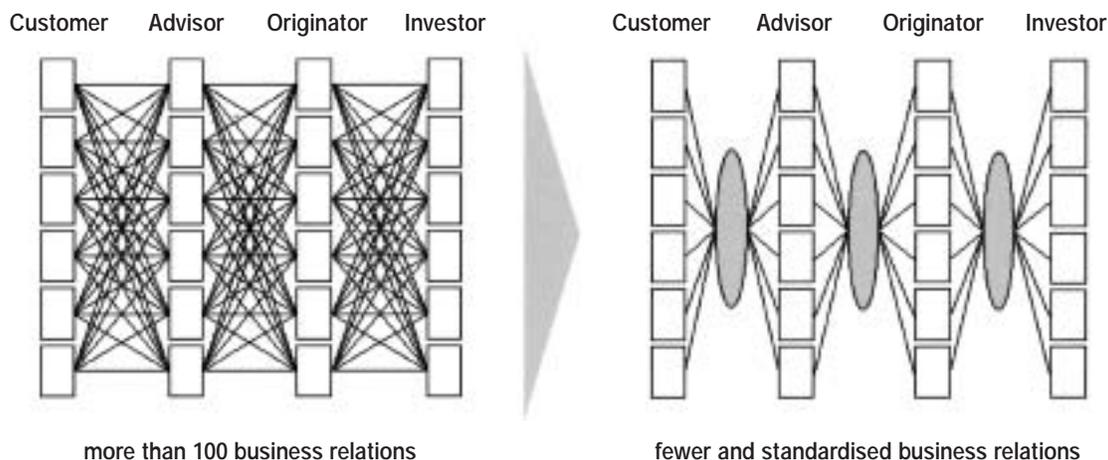


Fig 6: Growing efficiency in the market through standardised intermediary platforms

and regulations however is not efficient for highly specialised market players.

With a growing number of market players the complexity of business relations rises disproportionately without harmonised standards (see figure 6). Attempts by the associations or bilateral conversations to find a solution to this problem often fail due to the short-term self-interest of significant actors. Therefore, specialists had and still have to emerge to satisfy needs on the individual steps of the value chain. They will make the integration of all participating market players a business objective to be pursued insistently.

a. Integration of Borrower and Advisor by intermediary

For most private customers the mortgage loan is the major financial commitment in their life. In making their decisions they are facing an unmanageable number of intermediaries, "Bausparkassen" and wholesale banks. Due to the weak customer loyalty through the Internet, the customer evaluates a wide range of offers.

The use of various advisor-specific request tools has not been proven to be customer-oriented. As a consequence www.vergleich.de (English: comparison) has evolved into the leading integrator.

Prices, consumer reports and appraisals of customers and advisors are collected and evaluated within one platform. Customers can read and compose consumer reports in communities and have the top offers for their own financial requirements advised. Moreover, the customer only needs to enter the credit enquiry once and can then send it to numerous advisors with only one mouse click. Presently, www.vergleich.de is an important marketing instrument and quality assurance for advisors. They achieve to win potential customers at little expense because of an advantageous positioning through price and quality. In the meantime, the content of www.vergleich.de has been provided to many important platform-ports, business papers, real-estate bourses and consumer ends in Germany.

b. Integration of Advisor and Originator by intermediary

So far, the handling of mortgaging by advisor and originator has been known as the classical intermediary market. Due to the intensive and extensive information exchange between these two parties in particular, the need for integration of the two of them was much greater than in other markets along the value chain. The use of an integrator will provide optimal and standardised processes for both the advisor and the originator.

"europace" is in integrating software platform used by leading originators and advisory organisations. Three out of the five largest intermediaries, MLP, AWD and Dr. Klein & Co, are using this platform as well as all large specialised originators such as DSL Bank, AHBR, LBBW and WestImmo. europace offers a unique technically and legally standardised business relationship and also the corresponding front and middle office solutions for all market players. europace presents all functionality necessary on this step of the value chain as there are advisory tools, property valuation, scoring, price calculation, contract documents, payout processing and commission calculation engines.

With the use of front and middle office solutions by europace, an improved integration of advisors and originators is being generated and results in highly efficient and synchronous information flows. The advisor, for instance, needs to enter the customer's data only once and receives an overview of loan offers from different originators. With the help of appropriate interfaces, the originator is able to produce large new business volumes with different advisors just by customising the system. europace electronically collects the commissions from the originators and also provides the appropriate electronic compensation system to handle the commission calculation for all advisors.

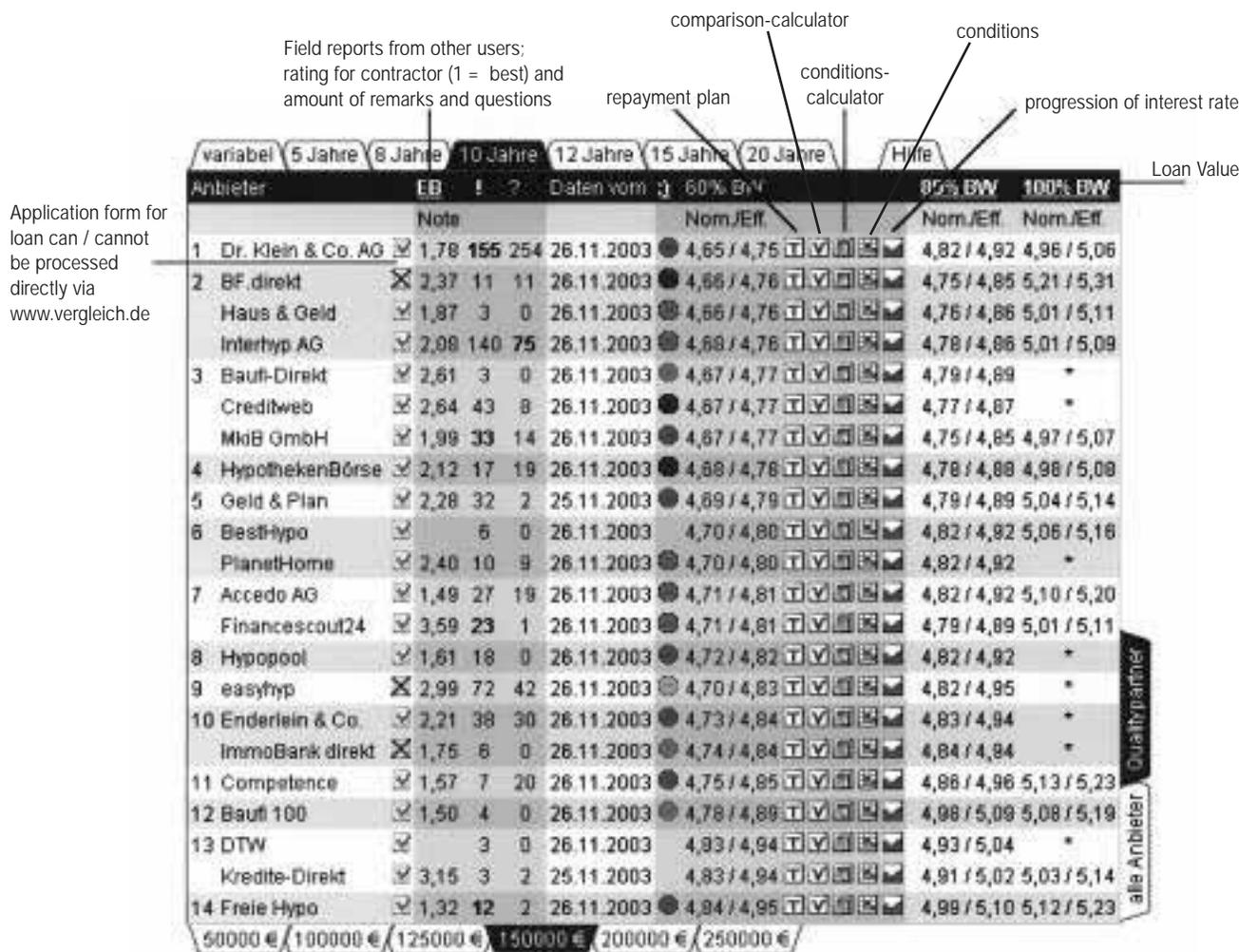


Fig 7: Screenshot of www.vergleich.de

c. Integration of Originator and Portfolio-Manager by intermediary

At present, there is an increasing need for bundling small-sized loan portfolios to critical masses arising in Germany. Creditshare AG is supporting the actors in terms of professional, legal and technical topics.

Besides networking, this integrator focuses on neutral portfolio evaluations by simulating the rating agencies' standard models. The result is then useable as indication for purchase price negotiations and thus allows a fair market price calculation. The development of technical standards is still in its early stages due to

very different system infrastructures at banks.

The integrator makes a simple refinancing accessible to originators of small-sized portfolios without the need to build up know-how of the capital markets. The purchaser of the portfolio generates critical mass and diversification. The integrator is adding evident value as intermediary for the respective parties and providing a neutral evaluation.

d. Integration of Portfolio-Manager and Investor by intermediary

Similar to other countries, investment banks in Germany also dominate the intermediary market for credit portfolios and Asset Backed Securities. They act as intermediary for portfolio managers and investors. Nevertheless, this is also an attractive market for an integrator who will represent the interests of portfolio banks and investors in dialogue with the investment banks and can contribute to an increasing quality of the reporting to investors via system integration. Hypoport AG was established as the securitisation integrator with the first German multiseller-transaction being reported via Hypoport software.

6 Integration of the intermediary markets via standard IT

Different market segments for integrators have developed along the value chain in Germany. Although each integrator is already providing higher efficiency in its market segments, the full potential has not yet been tapped. Integrators from all sub-segments therefore need to integrate all their IT systems into a standard IT

technology. Doing so guarantees a straight-thru processing in the near future. The use of object-oriented data structures allows the entry of completely new investor criteria into the platform. This leads to a modified application forms at the advisor front-end in only a few seconds and consequently to a differentiated market-oriented pricing. The necessary standardisation can only be pushed by integrators since they are taking up a neutral market position and have the

ability to convince market players of common standards.

The German mortgage market is becoming more and more attractive for foreign investors due to slightly increasing margins. Integrators allow for the access to a wide range of services. In this context, leading integrators are making any entry into the value chain possible through a one-stop-shopping.