2002

Annual Report

Verband deutscher
Hypothekenbanken
Association of German Mortgage Banks

Contents

The **Association of German Mortgage Banks (VDH)** comprises 19 private German mortgage banks. The mortgage banks are among the most important providers of capital for residential and commercial property as well as of loans to the public sector, i.e. the federal government, the federal states and the local authorities.

Bundling the mortgage banks' specific interests at Association level is an essential approach to effectively helping shape the legal framework and market-related policies. The VDH carries out this function on behalf of its member institutions and does so at all political levels working with all relevant legislative and executive bodies, domestically as well as in the international environment, including the European Union.

The classical funding instrument of the German mortgage banks, the Pfandbrief, is the largest asset class on the European bond market. The legal framework that governs the issuance of Pfandbriefe, the Mortgage Bank Act, adheres strictly to the principle of creditor protection.

The importance of international markets for the mortgage banks has grown steadily in recent years. Since the beginning of July 2002, the Mortgage Bank Act for the first time permits the mortgage banks to engage in mortgage and public-sector lending outside Europe – in the USA, Canada and Japan.

Member Institutions of the Association of German Mortgage Banks

Germany's private mortgage banks at work in 2002

The business trend of the German mortgage banks in 2002 is to be seen in the light of an extremely difficult market environment. The sharp downswing in the building sector continued with undiminished intensity and contributed, together with the weakening property markets in Germany and Europe as well as the unsatisfactory margin situation in public-sector finance, towards a decline in the volume of new mortgage and public-sector loan commitments for the third year in succession. To be specific, in the year under review the VDH member institutions gave mortgage and public-sector loan commitments totaling € 113.8 billion, which was 17.2% down on the previous year. To be more specific, property loans were extended totaling € 39.2 billion, representing a decline of 14.7%, while lendings to central governments and their institutions fell by 18.5% to € 74.6 billion.

New residential construction finance, particularly in the rented housing segment, was especially weak (– 33%). The significance of commercial property loans, first and foremost cross-border loans, grew further. In 2002, loan commitments in commercial property (€ 23.9 billion)

Member institutions of the Association of German Mortgage Banks

Allgemeine HypothekenBank Rheinboden AG Member of the BHW Group	Berlin Hyp Berlin-Hannoversche Hypothekenbank AG	DEUTSCHE HYPO Deutsche Hypothekenbank (Actien-Gesellschaft)	DEXIA Hypothekenbank Berlin
Deutsche Genossenschafts-Hypothekenbank DG HYP	DHB Düsseldorfer Hypothekenbank AG	EURO HYPO	HKB Hypotheken- und Kommunalkredit-Bank AG
Banking for Professionals HVB RealEstate	Hypothekenbank in Essen AG	HypoVereinsbank	Karstadt Hypothekenbank
Münchener Hypothekenbank eG	SEB Hyp	M. M. Warburg & CO Hypothekenbank	Die WestHyp Westfälische Hypothekenbank AG
WL BANK	Württemberger Hypo	wüstenrot Wüstenrot Hypothekenbank AG	Guest member: Deutsche Schiffsbank

exceeded residential loans (€ 15.2 billion) by a ratio of 61 to 39. Every second euro lent in commercial property finance was accounted for by a country of the EU or EEA. Once again, the main countries targeted by the German mortgage banks were Great Britain, France, Spain, and the Netherlands. In public-sector lending, too, the foreign markets have risen in importance given the difficult margin situation at home. Whereas, on the German domestic market, commitments for public-sector lendings fell by 24.2% to € 54.6 (72.0) billion over the previous year, foreign lendings rose by 2.8% to € 20.1 (19.5) billion.

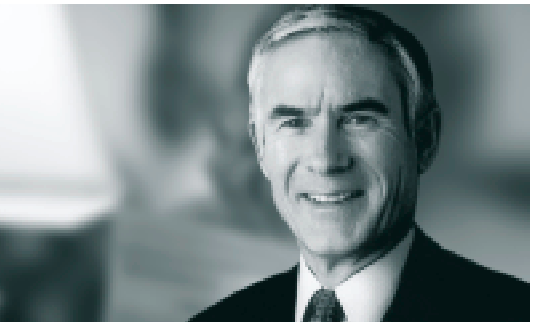
The loan portfolio as at December 31, 2002 amounted to € 830 billion, breaking down to 44% for mortgage loans and 56% for public-sector lendings. Of the mortgage loan book, 62% are residential loans and 38% commercial property loans.

In the year under review, the VDH member institutions issued bonds with an aggregate volume of € 144 billion. As at December 31, 2002, the mortgage banks had bonds worth € 702 billion outstanding. Mortgage Pfandbriefe represented € 209 billion of this total, and Public Pfandbriefe € 432 billion.

The German private mortgage banks at work 1998 – 2002

€ billion	1998	1999	2000	2001	2002
LENDING					
New commitments – total –	**191.0**	**198.0**	**154.8**	**137.5**	**113.8**
Mortgage loans	56.5	55.3	46.7	45.9	39.2
Public-sector loans	134.5	142.7	108.1	91.6	74.6
ISSUING					
Gross sales of bonds	**180.1**	**185.1**	**188.3**	**149.0**	**144.0**
Net sales	**88.7**	**93.2**	**39.9**	**6.8**	**– 35.9**
Loans outstanding – total –	**696.8**	**794.6**	**841.5**	**867.6**	**829.7**
Mortgage loans	302.7	326.3	342.7	359.1	367.8
Public-sector loans	394.1	468.4	498.8	508.5	461.9
Bonds outstanding – total –	**597.8**	**690.9**	**730.8**	**737.6**	**701.7**
Mortgage Pfandbriefe	175.5	182.5	192.8	200.4	208.7
Public Pfandbriefe	369.7	441.6	468.8	467.4	432.5
Other bonds	52.6	66.8	69.2	69.7	60.5

Foreword



Dr. Karsten von Köller
President

Dr. Louis Hagen
General Manager

2002 was an extremely difficult year for the entire German banking industry. Initially it appeared that the economic consequences of the terrorist attacks in the USA were absorbed relatively well, but in the end the negative fundamentals – augmented by a massive loss of confidence triggered by accounting scandals – globally prevailed. Unfortunately, Germany was not immune to these adverse developments and its implications for the lending and funding activities of the mortgage banks. The downswing of the property markets in Germany and Europe coupled with a simultaneous worsening of the risk situation forced the member institutions to exercise restraint in their property lending activities. Given the deteriorating funding conditions and an at times difficult capital market environment, risk-free but low-margin loans to the public sector did not provide a lucrative alternative either. On the contrary, these activities were also scaled back considerably. Positive developments in 2002, such as the amendment of the Mortgage Bank Act (HBG), which bolsters not only the quality of the Pfandbrief but also the earnings potential of the mortgage banks, or the successes achieved in Basel regarding the treatment of mortgage loans, were dominated by the negative sentiment. However, these achievements are likely to bear fruit once the overall economic situation improves.

In this environment, the situation of the mortgage banks in the year under review was again characterized by the need to optimize lending and funding operations and to reassess – where necessary adjust – their market positioning. Risk-adequate margins used to be almost impossible to achieve in the domestic lending business due to the fragmented German banking landscape, which is structured in a way that deters competition. But an increased earnings sensitivity even in segments of the banking sector which traditionally showed little orientation on earnings coupled with credit and market risks that increasingly materialized have led to a situation where loans are no longer granted at all cost. This more selective approach has resulted in generally improved overall margins. With the widespread weakening of real estate markets, even foreign property lending declined for the first time. Taking the first US financings onto the books did not sufficiently compensate for this trend. However, it was possible to refute the occasionally expressed fear that mortgage banks, lured abroad by higher margins, would disregard the risks of this business. Only foreign public-sector lending activities showed positive growth rates. However, since this field of business is still of little significance compared to domestic public-sector lending, the strong decline was barely cushioned.

In funding operations, too, the ongoing internationalization of the markets has made it significantly harder to get the attention of investors. Today, the Pfandbrief no longer just competes with bonds issued by the German federal government and by banks. But mortgage banks' funding activities have been hit hardest by the growing concern of the rating agencies – and, in consequence, of the investors – about the state of the German banking industry. This has resulted in a steep rise in funding costs, above all for uncovered bonds, a trend that the

Pfandbrief could not completely avoid. The downgrading of Pfandbrief issues resulting from Moody's rating approach have led to spread widenings versus the swap curve and of Pfandbrief issues relative to each other. These developments are harmful to the standing of the Pfandbrief as they bring with them the danger of viewing this unique instrument as a "normal" credit product.

The mortgage banks have developed and implemented individual strategies in response to the changing competitive situation in their core markets. Over the last few years, they have undergone a noticeable consolidation process, during which the market share of the mixed mortgage banks has increased greatly as of late. But the institutions do not consider economies of scale to be the only response to the intense competition on their markets. Some banks succeeded by focusing on niche markets. Cooperation between individual banks and the outsourcing of services, for example in IT or in the back office, are among the strategies of coping with the pressure to cut costs and to raise earnings.

These individual strategies pursued by the member institutions have been accompanied by numerous activities of the Association. For example, the Association has spoken with the leading rating agencies and analysts. The main objective of these meetings has been to make every attempt to clear up misunderstandings in order to improve the assessment of the Pfandbrief, and to identify weaknesses so that they can be remedied under future amendments of Pfandbrief legislation. It must be the goal of the Association to safeguard the high quality of the Pfandbrief while consistently developing the mortgage banks' business model in line with customer requirements and thus to ensure the profitability of the institutions. One of the paramount tasks in connection with any amendment of the Mortgage Bank Act is to highlight the Pfandbrief's benchmark status on the covered bond market. The mortgage banks must help safeguard the status of their name brand, the Pfandbrief, which is not only deserved, but is also needed to be the credit benchmark of the European capital market. Wherever the markets demand greater transparency, it must be provided. This is true in particular concerning the issue of how to assure the overcollateralization of the cover pools and the detailed rules governing the cover pools in the event of a mortgage bank's insolvency. With regard to overcollateralization, a positive impact can be expected from the conclusion of the regulation on the net present-value calculation of cover, which was introduced with the last amendment of the Mortgage Bank Act and was the subject of in-depth debate between the Federal Authority for Financial Services Supervision (BaFin) and the Association. At the same time, the effectiveness of voluntary measures was demonstrated in the year under review by the rules of good conduct for the issuance of Jumbo Pfandbriefe and the self-imposed restrictions concerning the investment of available funds. In this way, the member institutions of the Association of German Mortgage Banks are demonstrating once again their unconditional commitment to the Pfandbrief.

Berlin, March 2003

Dr. Karsten von Köller
President

Dr. Louis Hagen
General Manager

The Bond Market

Bond price quotations began the start of the year under pressure – mirroring the temporary recovery of the markets for equity capital. As the global economic prospects dimmed from early summer onwards, investors increasingly switched to fixed-income securities in the year under review. The uncertainty about military intervention in Iraq further served to dampen market sentiment. A general drop in yields was the result. By year-end, the yield curve across all maturity ranges was at least 50 basis points below the curve at the start of the year. The European Central Bank's "big step on interest rates" in early December 2002 steepened the curve only slightly.

Issuers took advantage of the favorable capital market environment and expanded their funding activities. The public sector was in the lead and more than tripled its net borrowing compared to the previous year.

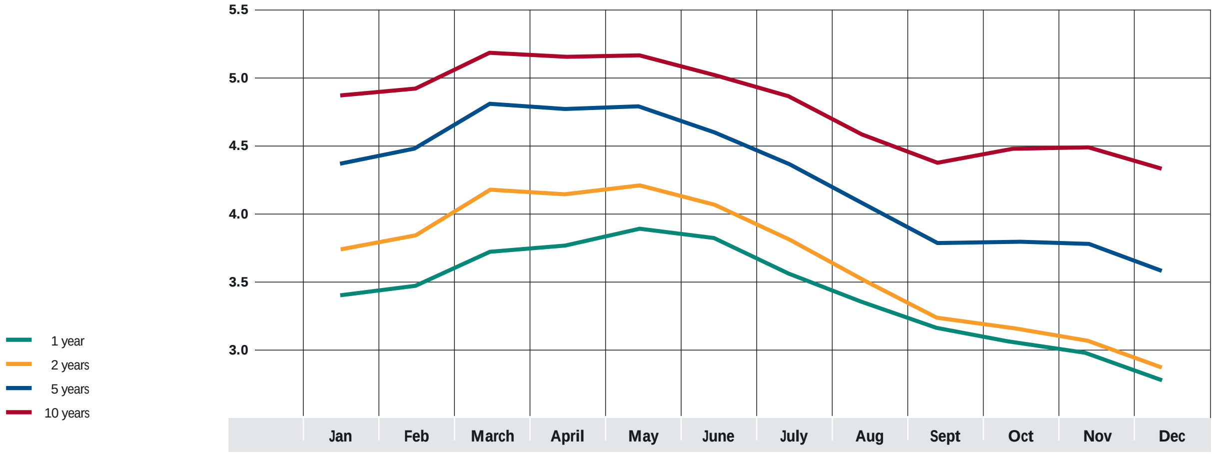
1 Development of interest rates

Uncertainty on the financial markets

The development of interest rates in the year under review was erratic. Driven by temporarily improved fundamentals that pointed to a recovery of world economic activity, the yields of German federal government paper continued their rise which had begun in the late autumn of the previous year until the early summer of the year under review.

Development of Interest Rates 2002

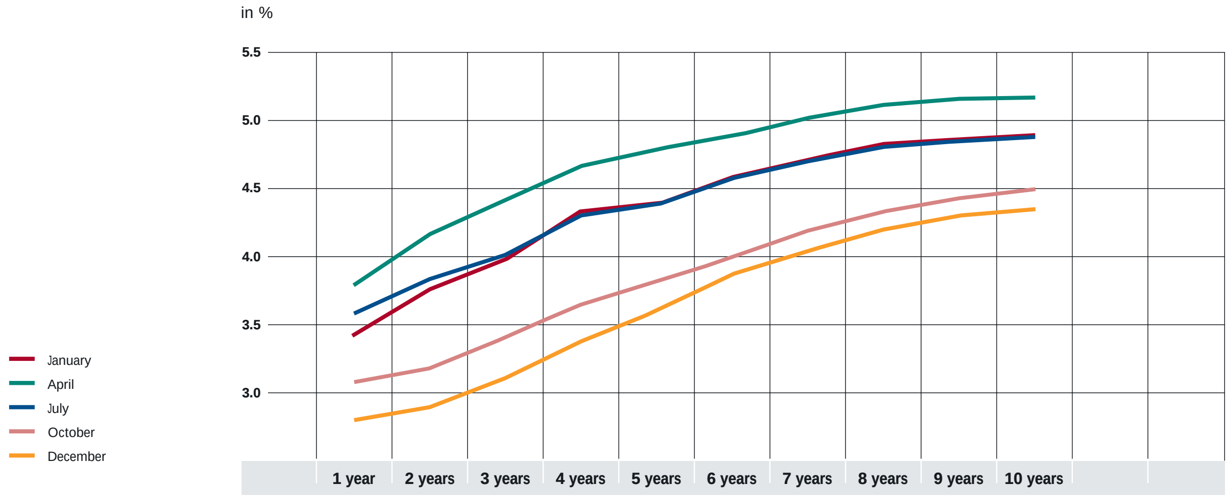
in %



Source: Bloomberg, generic yields of Bunds, basis: monthly averages

As a result, the yield curve initially flattened. In a market environment characterized by widespread uncertainty, prices on the bond markets rose sharply beginning with the end of the second quarter onwards. In light, above all, of rising tensions in the Middle East, expectations of a lasting improvement of the economic environment in the USA and Europe were again frustrated. Yields fell substantially across the entire maturities spectrum during the rest of the year. On balance, they slipped in the ten-year category by some 60 basis points, and by 70 basis points in the case of paper with a five-year residual life. By year-end, following the ECB's cut on key lending rates by 50 basis points at the beginning of December, two-year German government bonds were yielding some 80 basis points less than at the start of the year. As a result, the yield curve of public-sector bonds moved downwards over the year as a whole and steepened compared to the beginning of 2002.

Development of the Yield Curve in 2002



Source: Bloomberg, generic yields of Bunds, basis: monthly averages

2 Sales and volume outstanding on the German bond market

Issuers take advantage of low capital market rates

In the year under review, domestic issuers tapped the capital market for a total of €861 billion, which was 20% more than in the previous year (€718 billion). Especially the public sector was raising its level of borrowing. But other groups of issuers also took advantage of the favorable terms for raising funds on the capital market. Collectively, banks sold paper totaling €612 billion in 2002 (+ 14%), compared with €535 billion in 2001.

Sales of Fixed-Income Securities 2002*

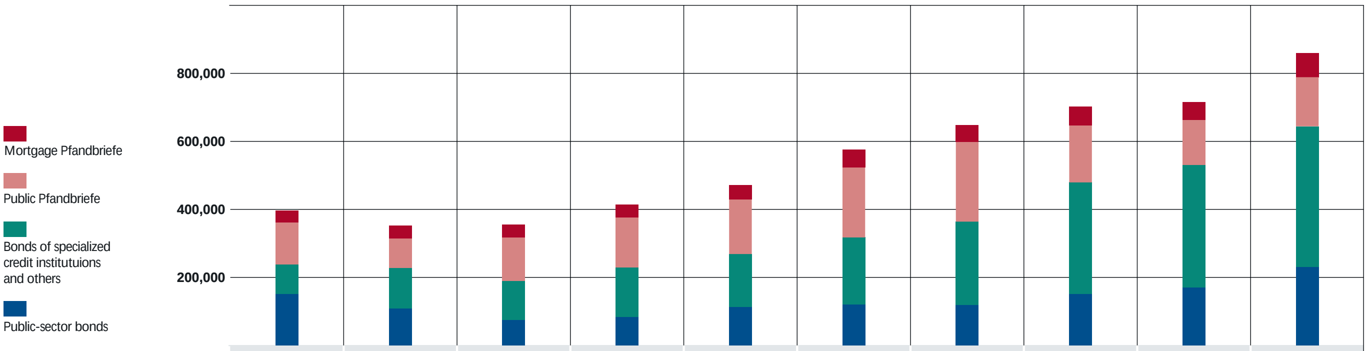
Nominal value € million	Gross sales 2002	Gross sales 2001	Change in %	Net sales 2002	Net sales 2001	Change in %
Mortgage Pfandbriefe	51,784	44,013	17.6	5,292	8,389	– 36.9
Public Pfandbriefe	146,406	129,972	12.6	– 22,095	– 9,685	– 128.1
Total Pfandbriefe	**198,190**	**173,985**	**13.9**	**– 16,803**	**– 1,296**	**– 1.196.5**
Bonds of specialized credit institutions	121,307	107,612	12.7	22,433	45,392	– 50.6
Other bank bonds	292,180	253,948	15.1	54,226	16,828	222.2
Corporate bonds	17,574	11,328	55.1	14,307	8,740	63.7
Public-sector bonds	231,923	171,012	35.6	61,277	14,478	323.2
Total domestic fixed-income securities	**861,174**	**717,885**	**20.0**	**135,440**	**84,142**	**61.0**
Bonds of foreign issuers	10,313	10,605	– 2.8	– 44,544	– 30,657	– 45.3

* incl. registered bonds

Source: Deutsche Bundesbank, Capital Market Statistics

Gross Sales of Fixed-Income Securities* 1993 – 2002

€ billion
*Market share in %***



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total Pfandbriefe	157,753 *40%*	129,256 *37%*	165,982 *46%*	183,277 *44%*	203,208 *43%*	257,132 *45%*	281,907 *43%*	215,574 *31%*	173,985 *24%*	198,190 *23%*
Mortgage Pfandbriefe***	34,931 *9%*	37,236 *11%*	36,917 *10%*	36,128 *9%*	42,028 *9%*	50,000 *9%*	46,576 *7%*	49,553 *7%*	44,013 *6%*	51,784 *6%*
Public Pfandbriefe	122,822 *31%*	92,020 *26%*	129,065 *36%*	147,149 *35%*	161,180 *34%*	207,132 *36%*	235,331 *36%*	166,021 *24%*	129,972 *18%*	146,406 *17%*
Bonds of specialized credit institutions	18,726 *5%*	22,850 *6%*	23,427 *7%*	32,141 *8%*	31,420 *7%*	42,937 *7%*	68,839 *11%*	97,587 *14%*	107,612 *15%*	121,307 *14%*
Other bank bonds	68,021 *17%*	91,271 *26%*	91,536 *26%*	115,436 *28%*	124,067 *26%*	155,367 *27%*	176,521 *27%*	231,470 *33%*	253,948 *35%*	292,180 *34%*
Public-sector bonds	152,284 *38%*	109,550 *31%*	76,355 *21%*	85,474 *20%*	114,004 *24%*	121,892 *21%*	120,483 *19%*	150,137 *22%*	171,012 *24%*	231,923 *27%*
Corporate bonds	234 *0%*	248 *0%*	102 *0%*	891 *0%*	979 *0%*	1,734 *0%*	2,570 *0%*	8,114 *1%*	11,328 *2%*	17,574 *2%*
Total gross sales of domestic securities	**397,018**	**353,175**	**357,402**	**417,219**	**473,678**	**579,062**	**650,320**	**702,882**	**717,885**	**861,174**
Bonds of foreign issuers	44,640	31,427	52,519	57,454	58,703	76,460	57,202	31,597	10,605	10,313

* incl. registered bonds
** differences due to rounding
*** incl. Ship Pfandbriefe

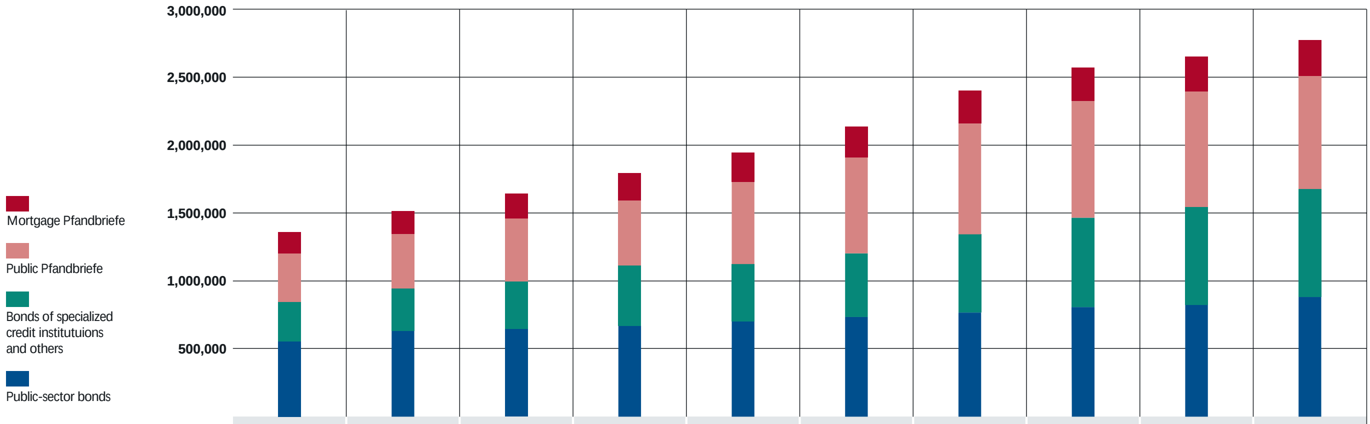
Source: Deutsche Bundesbank, Capital Market Statistics

Increase in German bonds outstanding

As at end-2002, total bonds outstanding of domestic issuers amounted to €2.81 trillion, representing a growth of 5% over the year before (€2.67 trillion). In terms of paper outstanding, Pfandbriefe again ranked first on the German bond market with a volume of €1.09 trillion.

Fixed-Income Securities Outstanding* 1993 – 2002

€ million
*Market share in %***



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total Pfandbriefe	509,375 *38%*	564,317 *37%*	642,967 *39%*	731,643 *41%*	814,515 *42%*	932,359 *44%*	1,056,290 *44%*	1,106,130 *44%*	1,104,834 *41%*	1,088,031 *39%*
Mortgage Pfandbriefe***	146,222 *11%*	164,465 *11%*	181,156 *11%*	194,923 *11%*	209,758 *11%*	226,607 *11%*	235,800 *10%*	247,484 *10%*	255,873 *10%*	261,165 *9%*
Public Pfandbriefe	363,153 *27%*	399,852 *26%*	461,811 *28%*	536,720 *30%*	604,757 *31%*	705,752 *33%*	820,490 *34%*	858,646 *33%*	848,961 *31%*	826,866 *29%*
Bonds of specialized credit institutions	122,427 *9%*	120,342 *8%*	123,533 *8%*	130,779 *7%*	139,766 *7%*	153,273 *7%*	191,982 *8%*	175,048 *7%*	220,440 *8%*	242,873 *9%*
Other bank bonds	173,884 *13%*	200,749 *13%*	230,303 *14%*	260,466 *15%*	284,243 *15%*	316,703 *15%*	378,805 *16%*	485,420 *19%*	502,248 *19%*	556,474 *20%*
Public-sector bonds	549,855 *40%*	628,405 *42%*	644,785 *39%*	666,662 *37%*	701,141 *36%*	731,959 *34%*	768,783 *32%*	805,786 *31%*	820,264 *31%*	881,541 *31%*
Corporate bonds	1,617 *0%*	1,586 *0%*	1,404 *0%*	1,703 *0%*	2,501 *0%*	4,095 *0%*	6,280 *0%*	13,599 *0%*	22,339 *1%*	36,646 *1%*
Total domestic fixed-income securities outstanding	**1,357,158**	**1,515,399**	**1,642,992**	**1,791,253**	**1,942,166**	**2,138,389**	**2,402,140**	**2,585,983**	**2,670,125**	**2,805,565**
Bonds of foreign issuers	163,396	174,458	205,656	241,422	273,725	316,831	339,560	322,856	292,199	247,655

* incl. registered bonds
** differences due to rounding
*** incl. Ship Pfandbriefe

Source: Deutsche Bundesbank, Capital Market Statistics

3 Sales of euro-denominated bonds in Europe

According to information from the EU Commission, issuers of euro-denominated bonds recorded sales of €1.47 trillion in the year under review, matching the previous year's result.

Central government bonds dominated the market, their share of gross sales rising strongly by 10% to €700 billion. With a share of 48%, these issuers absorbed almost every second euro of funds raised through first-time issues on the euro capital market. Bank bonds again accounted for €280 billion or a market share of 19%. Pfandbriefe and Pfandbrief-similar products generated sales of €197 billion (an increase of 4%). With 13%, their share of total sales was unchanged versus the previous year.

There was a plunge in corporate bond sales. After €209 billion one year earlier, sales in this bond category achieved only €118 billion (– 44%). Finally, gross sales of asset backed securities increased by €4 billion to €65 billion.

Funding Activities of the Mortgage Banks

In the year under review, it became apparent that the mortgage banks are expanding their real estate lending operations on the one hand, while holding back in public-sector lending on the other. This is reflected in the growing importance of Mortgage Pfandbriefe in funding operations. On the whole, the institutions were confronted with a persistently difficult market environment. Gross sales of bonds fell by 3.4% to approx. €144 billion. In net terms, repayments of maturing bonds exceeded funds raised by €40.6 billion. The volume of Jumbo Pfandbriefe outstanding rose to €406 billion (2001: €403 billion).

1 The business figures

Differing developments of gross sales of Mortgage Pfandbriefe and Public Pfandbriefe

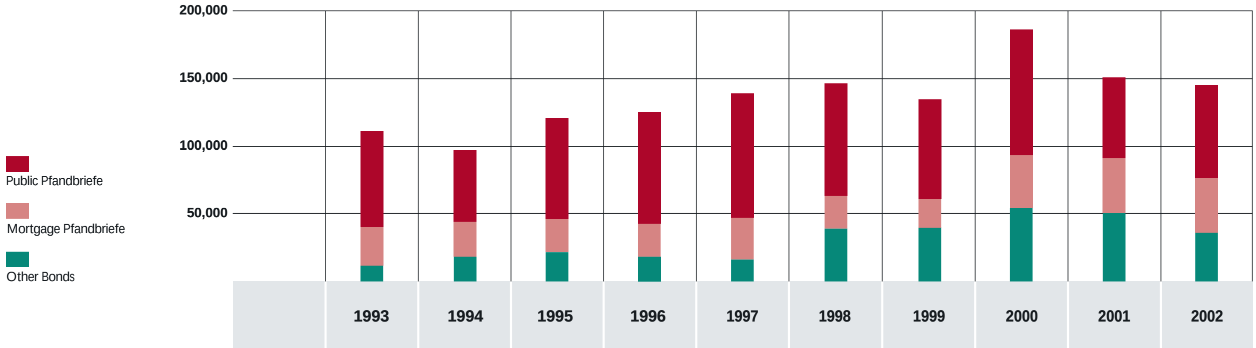
Gross sales of bonds issued by the mortgage banks fell in the year under review by 3.4% to €144.0 billion. The heaviest decline was recorded for other bonds, with sales dropping by 32.1%, from €53.0 billion to €36.0 billion. This can be explained by the fact that in some cases the mortgage banks' funding through uncovered paper became considerably dearer. For this reason, the mortgage banks are very much interested in including eligible business in the cover pools, and funding it through Pfandbriefe.

Over the course of the year, sales of newly issued Mortgage Pfandbriefe rose vigorously by 35.3% to €40.9 billion, after slumping by 24.6% one year before. This increase also reflects the growing significance of real estate lending to the mortgage banks. Given the better margin situation, the banks attach importance to commercial mortgage lending abroad. The mortgage banks are likely to continue expanding their property finance activities in the current year so that a further increase in Mortgage Pfandbrief sales may be expected.

Gross sales of Public Pfandbriefe rose only slightly; issuance grew by 1.9% to €67.1 billion. The reasons for this development are varied. For one thing, the mortgage banks exercised restraint in public-sector lending due to often unfavorable market conditions. For another, sub-sovereign regional authorities are themselves increasingly assuming the function as issuers on the primary market.

Issuance of Bonds* by Mortgage Banks

€ million



* incl. registered bonds

Gross sales

€ million	2002	2001
Mortgage Pfandbriefe	40,857	30,199
Public Pfandbriefe	67,120	65,868
Other bonds	35,997	52,984
Total	**143,974**	**149,050**

Source: VDH statistics

Net sales

As in the year before, net sales fell far more strongly than gross sales in the year under review. Repayments of maturing bonds were well in excess of funds raised, resulting in a volume of – €35.9 billion.

This was primarily due to the declining net sales of Public Pfandbriefe, in the case of which repayments of maturing bonds exceeded funds raised on the capital market by €39.7 billion in the year under review. And with a volume of – €9.2 billion, net borrowings through uncovered bonds were also down on the previous year.

In 2002, the net availment of the capital market through Mortgage Pfandbriefe rose, in contrast to Public Pfandbriefe, by 7.8% to €8.3 billion. The main reason for this reduction in net sales is to be seen in the persistently difficult operating conditions for lending.

Net sales

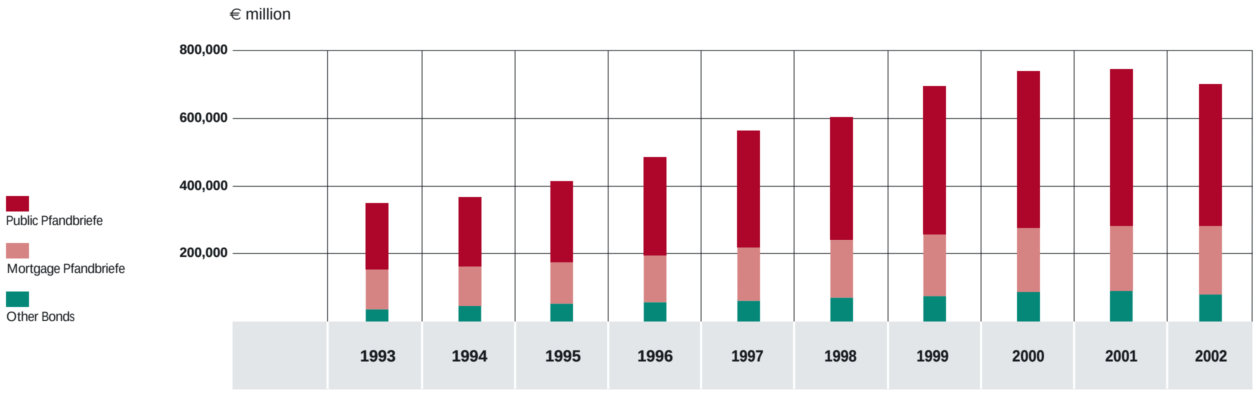
€ million	2002	2001
Mortgage Pfandbriefe	8,256	7,659
Public Pfandbriefe	– 34,963	– 1,322
Other bonds	– 9,165	426
Total	**– 35,872**	**6,763**

Source: VDH statistics

Bonds outstanding

As a result of the subdued development of gross and net sales, the volume of bonds outstanding issued by mortgage banks in 2002 fell by 4.9% to €701.7 billion. Mortgage Pfandbriefe outstanding recorded a distinct increase, by 4.1% to €208.7 billion, whereas Public Pfandbriefe outstanding fell by 7.5% to €432.5 billion, as did the volume of other bonds outstanding by 13.2% to €60.5 billion. Seen as a whole, therefore, the aggregate volume of bonds outstanding reached the level of 1999. This is an indication that the mortgage banks put more emphasis on qualitative growth than on quantitative growth.

Bonds Outstanding issued by the Mortgage Banks* 1993–2002



* incl. registered bonds

€ million	Public Pfandbriefe	Mortgage Pfandbriefe	Other bonds	Total
1993	188,863	119,345	28,642	336,850
1994	203,557	130,399	32,033	365,989
1995	241,511	142,489	37,368	421,368
1996	292,517	153,431	40,608	486,556
1997	350,138	167,945	43,034	561,117
1998	369,657	175,470	52,629	597,756
1999	441,633	182,515	66,791	690,939
2000	468,769	192,779	69,257	730,795
2001	467,438	200,438	69,682	737,558
2002	432,475	208,694	60,517	701,687

Figures since 1998 without DePfa

Source: VDH statistics

Market shares fall further

In light of the developments described above, it is no surprise that the shares accounted for by the mortgage banks on the bond market decreased in 2002. With a volume of bonds outstanding of €701.7 billion, the mortgage banks together represented one quarter (25%) of all bonds issued by domestic issuers. Only one year ago, their share had been 27.6%. The mortgage banks’ share of the market for bank bonds reached 37.2% (previous year: 40.1%).

Gross sales of bonds issued by mortgage banks amounted to €144 billion in the year under review, representing a market share for new bond issues of 16.7% (previous year: 20.8%). On the market for bank bonds, meanwhile, this share was 23.5% (27.9%).

2 Lines of development in the mortgage banks’ funding environment

Decreasing growth on the Jumbo market

At the end of 2002, the outstanding volume of the German Jumbo market was slightly above previous year’s figure for the same period (€403 billion) at approximately €406 billion. This means that the weakened growth momentum of the Jumbo market observed in previous years continued. Whereas in the years 1995–1998, yearly growth rates of 100% were the rule, growth dropped to 22.7% in the year 2000, and to 9% in 2001.

From this fact, it can easily be seen that the Jumbo Pfandbrief, now in its ninth year, is showing the typical signs of a maturing market. The mortgage banks' reorientation, already mentioned, and continued uncertainty on the capital market were also determining factors. However, this has not affected the importance of the Jumbos for the international investor base of the mortgage banks. Yet the Jumbo market should not be considered on its own, but in connection with the traditional Pfandbriefe. In this less liquid sector, Pfandbriefe enjoyed markedly more attractive conditions. This shows that both markets are essential to the mortgage banks and that they contribute to the diversification of the funding base.

In light of the increasing role played by mortgage lending, it may be assumed that on the Jumbo market the share of Jumbo Mortgage Pfandbriefe will grow. Their share of aggregate issuance in the Jumbo segment already advanced strongly from 17% in 2001 to 25% in 2002.

Different rating methods result in differentiations on the Pfandbrief market

The Pfandbrief market last year saw growing divergences between the ratings by different rating agencies for Pfandbriefe of the same issuers. This is due to the different rating approaches applied by the agencies. Whereas Moody's derives the rating of Pfandbriefe from the senior unsecured issuer ratings and to a limited extent takes the quality of the cover pool into consideration through the possibility to notch up, the rating procedure at Standard & Poor's is based solely on the quality of the cover pools. The method applied by Fitch, meanwhile, lies between these two approaches.

The issuer rating at Moody's has so far focused exclusively on the rating of the parent banks, so that the downgrading of the parent automatically results in the subsidiary being downgraded. The latter part of the year under review was characterized in some cases by substantial downgradings of banks, and these resulted at Moody's – given the automatism described above – in downgradings of the mortgage banks and subsequently of their Pfandbriefe. Thus, these downgradings are not the result of a poorer assessment of the quality of the Pfandbriefe themselves. The Pfandbrief ratings awarded by the other two big agencies, on the other hand, remained stable. Where there are split ratings, it is usually the poorer rating that has a stronger impact on market perceptions. As a result, the spreads between the Pfandbriefe of different issuers have widened. In this context one should not overlook the fact, however, that the spreads are still narrow compared to those for corporate issuers with the same rating.

These developments prompted the VDH to seek a constructive dialogue with the rating agencies to clear up possible misinterpretations of the Mortgage Bank Act on the one hand, and to take note of justified criticism that could benefit the future development of the Pfandbrief on the other. The aim of the VDH is to see the spreads narrow again. A complete uniformity of prices is neither achievable nor desirable, since the mortgage banks are also competing with each other. The framework the Mortgage Bank Act offers should, however, continue to guarantee such a high standard of quality that spread differentials remain within very tight limits. This is desirable, since the Pfandbrief lives by its high degree of homogeneity, from which all issuers ultimately benefit.

Dynamic developments on the new markets for Pfandbrief-similar products

The new markets for Pfandbrief-similar products in other European countries experienced a very dynamic development in the year under review. The Spanish and French issuers in particular succeeded in expanding their Jumbo issues considerably. While Cédulas hipotecarias were issued with a total volume of some €8 billion in 2001, the total increased to €15 billion in 2002. Thus, the share of Cédulas of the total new issuance of European Jumbo covered bonds rose to roughly 20%. And including French and Luxembourg Jumbo issues, an aggregate volume of almost €25 billion or roughly one-third of all new Jumbos was issued outside Germany. This was a sizeable increase over 2001, when issues by non-German issuers amounted to €16.5 billion or approx. 19% of total Jumbo issuance. The above issues were sold, moreover, at similar or in some cases slightly better terms than Pfandbriefe.

On the basis of the new Irish covered bond law, so-called Asset Covered Bonds were issued for the first time at the beginning of 2003. The inaugural issue of Cédulas territoriales, the Spanish equivalent to the Public Pfandbrief, also appeared in early 2003. As a result, the covered bond market has become more varied. Even though these developments mean increased competition, they must be welcomed because the Pfandbrief, too, profits from the fact that this bond market segment is becoming broader and better established. Once again it is shown how the Pfandbrief inspires others, a trend that is not yet completed. The predominant view is that the potential for covered bonds is far from exhausted, and Obligations foncières and Cédulas in particular are considered by some to be highly promising. Yet it is to be expected that if the present trend continues, these bonds, too, will see their growth momentum slow down as their markets mature, much as growth of the Pfandbrief market did. Yet the brisk demand for covered bonds other than for the Pfandbrief is also an indication for the maturity of the Pfandbrief market. Following the rapid growth witnessed since 1995, this may by all means be considered a healthy development. Moreover, buyer interest in the respective bonds is still very much driven by national sentiment, which hampers sales of Pfandbriefe in these markets.

The expanded investment universe is a positive phenomenon for investors. However, the collective term “covered bond” that is often used internationally should not be allowed to disguise the substantial differences that exist in some cases in terms of credit quality and market liquidity.

Pfandbrief continues to dominate the European market for covered bonds

Despite the rise in issuance of Pfandbrief-similar products in other European countries, the German Pfandbrief still predominates the European market for covered bonds. The Pfandbrief’s share in the year under review was, at 73.5%, just short of the previous year’s 75%. Thus, the German Pfandbrief must be seen as the benchmark for the European market. Yet this should not mask the fact that efforts to enhance the Pfandbrief and to cultivate the market must continue unabated precisely for this reason.

3 Measures to boost Pfandbrief quality and to support the market

Rules of good conduct for the issuance of Jumbo Pfandbriefe introduced

Characteristic of the quality of the Pfandbrief is the great commitment of the mortgage banks for their traditional funding instrument. As a result, the issuers stand as one behind the product to protect it against any harmful influences. Moody’s interprets this as systemic support that gives the German Pfandbrief greater notching-up potential than other covered bonds. The mortgage banks were thus anxious to respond to the agitation in the market over allegedly opportunistic issuing practices. For this reason, the member institutions of the VDH agreed at the end of last year to observe in future the following rules of good conduct when issuing and re-opening Jumbo Pfandbriefe:

1. New issues and re-openings should be announced with an adequate run-up period to ensure enough time for the bookbuilding process. Every issue should be preceded by a pre-marketing phase of at least 24 hours.
2. New issues and re-openings should always be priced in line with prevailing market prices. The issuing spread should always be determined in such a way that it also holds up in the secondary market.
3. Re-openings must – like the corresponding new issues – as a general principle be carried out with the stipulated minimum number of market-makers.

4. The issuer should publish the information necessary for investors to assess the quality of the cover pools. The data should be updated quarterly.

No other issuing group commits itself in this manner. The rules of good conduct have been received by the market as an important contribution towards boosting the quality of the Pfandbrief, and have helped restore calm to the markets.

Adoption of self-imposed restrictions when investing available funds

The purpose of the legal regulation of the investment of “available funds”, namely to ensure the high quality of the investment of such funds, may not be properly realized by the criterion that the paper bought for this purpose must be quoted on a stock exchange of an EU member state. To rule out the possibility of unrest in the market from the very beginning, the VDH member banks adopted a further measure to ensure the quality of the Pfandbrief, namely the introduction of self-imposed restrictions when investing available funds in accordance with § 5 par. 3 no. 3 d and 5 HBG (Mortgage Bank Act). Until this point is regulated under a future HBG amendment, the mortgage banks belonging to the VDH have set themselves high standards of quality with regard to the investment of available funds. The rules are as follows:

1. Within the scope of the investment of available funds pursuant to § 5 par. 3 no. 3 d and 5 HBG, only receivables may be purchased that have received a rating from Moody’s, S&P or Fitch of at least A–/A3.
2. Where receivables have a split rating, the weakest individual rating applies.
3. In the case of the purchase of unrated receivables, it has to be verifiably documented that the internal credit assessment (internal rating) has revealed that the credit quality of the receivable in question is equivalent to at least the minimum rating of A– or A3 mentioned under Point 1.
4. The total volume of the receivables purchased in accordance with § 5 par. 3 no. 3 d and 5 HBG, the rating of which is poorer than A– or A3 after a downgrade, is limited to one time the liable equity capital.

HBG amendment: Safety of the Pfandbrief bolstered further

Diversification of business activities The HBG amendment, which came into force on July 1, 2002, for the first time grants mortgage banks the possibility to engage both in public-sector lending and in mortgage lending on the most important non-European markets in the- USA, Canada and Japan. This greater regional diversification enhances the quality of the mortgage banks’ portfolios and thus improves the safety of the Pfandbrief (for details see pp. 30).

Inclusion of derivatives in cover and present-value calculation of cover

The amendment of the HBG allows mortgage banks to make use of derivatives for the first time. The scope of the rules on derivatives covers the fundamental admissibility of the use of derivates and their inclusion in cover. Moreover, to ensure that the derivatives are properly represented in the calculation of cover, the net present-value calculation of cover has been introduced in addition to the nominal value calculation. These improvements are a further step towards boosting the quality of the Pfandbrief: Pfandbrief investors profit from the lasting enhancement of the instrument’s credit quality and the increased transparency of the cover pools afforded by the net present-value calculation of cover.

The provisions of the HBG amendment concerning derivatives have met with a positive echo from rating agencies and analysts alike, and are looked upon as a benchmark for rules of this kind to be applied to other Pfandbrief and mortgage bank laws (for details see pp. 31).

Communications Activities in 2002

The communications activities of the Association of German Mortgage Banks (VDH) during the financial year 2002 once again aimed at positioning the Pfandbrief on the national and international capital markets as a brand label for safety, yield and liquidity. Moreover, these activities serve to effectively represent the expertise of the VDH's member institutions in mortgage and public-sector finance and in the refinancing of these operations.

To ensure a constant flow of information on the Pfandbrief and the mortgage banks' lending activities both in Europe and beyond, the communications efforts of the Association in 2002 concentrated above all on instruments such as events held in Germany and abroad, meetings with the press, publications, and the Internet. The foremost objective of the advertising activities, which were less extensive than in previous years, was to draw attention to upcoming events and to attract even more users to the Association's homepage.

Events at the core of the Association's communications activities

A number of foreign events were held again in 2002, on the one hand to promote awareness of the Pfandbrief among international investors and, on the other hand, to inform market participants of the latest developments in the Pfandbrief market.

The London Pfandbrief Conference, which was held on September 12, 2001 on a much reduced scale due to the terrorist attacks in the USA the day before, was staged again on March 14, 2002. A good 130 participants demonstrated that the Pfandbrief still draws strong interest in London.

The Pfandbrief Conference in Tokyo was held on January 22/23, with more than 200 guests from Tokyo's financial community attending three different events. Since some of the lectures and speeches were published in its monthly magazine, the fifth joint seminar with the Securities Analysts Association in Japan had an especially broad impact. Moreover, meetings with institutions such as the Bank of Japan, the bank supervisory authority, market participants, and the press played an important role.

A further event in Japan followed in July. A seminar focusing on the amendment of the German Mortgage Bank Act was well attended by over 80 participants and found an echo in the Japanese media. Furthermore, talks were organized with a number of public-sector institutions in view of the new opportunities for German mortgage banks in public-sector finance.

The Association's Liaison Office (IFC) in Tokyo, in operation now for four years, has firmly established itself as an organizer of such events and as a permanent liaison office for investors in Japan.

Our presence on the US market in the year under review took the form of a Pfandbrief Conference in New York at the beginning of March and an Investor Conference in Boston in November. Both events were conducted jointly with the "Institutional Investor" magazine. Roughly 100 guests attended in New York, while the Boston conference, attracting 40 participants, was notable above all for the large share of institutional investors.

In conformity with the successful approach adopted in Japan, the VDH opened a liaison office in New York at the end of the year, involving the specialized agency Makovsky & Company to take on this task. The new office's foremost job will be to generate additional sales potential for the German Pfandbrief in the USA through intense communications and investor relations activities. Further tasks include lending issues, setting up contacts with public bodies against the background of the July 2002 amendment of the Mortgage Bank Act and organizing the Pfandbrief conferences.

In September, a conference on "Mortgage Lending in Europe" took place in Madrid by EuroCatalyst. Both the European Mortgage Federation and the VDH took part. The event was staged as a global information platform for European providers of residential building finance and is to be repeated once a year in the future. The exchange of views – in particular with US experts – is intended to enable the participants to gain an in-depth picture of competition in Europe and new trends in residential building finance.

At the end of May 2002, the European Mortgage Federation hosted the 2nd European Pfandbrief Conference in Brussels, at which the VDH moderated a panel discussion on the latest developments in the European Pfandbrief market. Not least in view of the future rules on the weighting of Pfandbriefe, the conference sought to present the European Pfandbrief market as a homogenous asset class to the decision-makers in the EU Commission, to elucidate the high quality of the European Pfandbrief and Pfandbrief-similar products, and to communicate latest developments in the member states with reference to the introduction of new mortgage bank and Pfandbrief legislation.

On November 7/8, the 6th Central European Pfandbrief Conference was held in Warsaw. 170 guests from 16 European countries attended this event, which was partially organized and financed by the VDH. The speeches and discussions centered on latest Pfandbrief-relevant issues of Europe-wide significance, such as the future of the specialist bank principle, the use of derivatives, the rating of Pfandbriefe, and Pfandbriefe and Mortgage Backed Securities as competing and complementary products.

Events in Germany very well attended

The traditional, domestic Pfandbrief-related events, “Pfandbrief Forum” in Gravenbruch and “Pfandbrief Evening,” held each year at a different leading German financial center, attracted a gratifying number of participants. Particularly the Pfandbrief Forum, with some 400 guests, has become a fixed point on the Pfandbrief community’s annual calendar. Guest speaker Christian Strenger, member of the Supervisory Board of DWS Investment GmbH and member of the Government Commission on the German Corporate Governance Code, addressed the question, “Corporate Governance of Interest also to Bondholders?”

To mark the centennial of the Association of German Mortgage Banks, VDH held a joint conference with the Börsen-Zeitung on November 14 in Frankfurt entitled “The Pfandbrief in the 21st Century.” At the heart of this half-day event, which was very well attended, not least by members of the press, was a panel discussion featuring top-level speakers: Mr. Caspari (Vice President of the Federal Authority for Financial Services Supervision, BaFin), Mr. Kengeter (Managing Director of Goldman Sachs), Dr. von Köller (President of the VDH), Mr. Sauer

(President of the Association of German Public Sector Banks (VöB) and Prof. Sinn (President of the ifo Institute for Economic Research). Speeches were given looking at different aspects of the Pfandbrief. Caspari emphasized the outstanding importance of supervision for the Pfandbrief, while Kengeter highlighted the continuing success story of the Jumbo Pfandbrief. Finally, von Köller explained VDH's thoughts on the future of mortgage banks. The contributions to the conference were published with other articles covering various aspects of the mortgage banks' business activities in a Börsen-Zeitung special supplement entitled "Mortgage Loan and Pfandbriefe – on the 100th Anniversary of VDH."

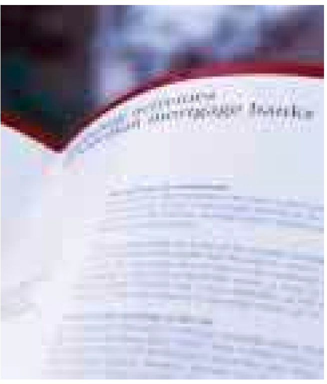
To position the mortgage banks in the public eye as the leading group of providers of property finance with cutting-edge expertise derived from specialization, two real estate forums – among other PR measures – were conducted in the form of moderated panel discussions.

A discussion of the topic "Urban Development in East Germany as a Challenge for State and Business" from the viewpoint of the housing sector, the mortgage banks and research took place on June 27 in Berlin and was chaired by Prof. Eekhoff of Cologne University. Speakers included Mr. Freitag (President of the Federation of German Housing Companies (GdW), Dr. Krewerth (DG HYP), Mr. Bulwien (Bulwien AG) and Dr. Schädlich (Leipzig University).

The 2nd Real Estate Forum was held under the heading "Global real estate cycles: Will Basel II have consequences for the property markets?" at the EXPO REAL in Munich. Moderated by the VDH, the Association's interactive panel discussion involving experts Hofmann (General Manager of BayWobau, Munich), Dr. Lutz (Department Head at BaFin) and Schmidt-Bürgel (Managing Director of Fitch Deutschland), was according to EXPO REAL the event with the best attendance of the official exhibitors' forum, with 184 participants.

Dialogue at the heart of PR work

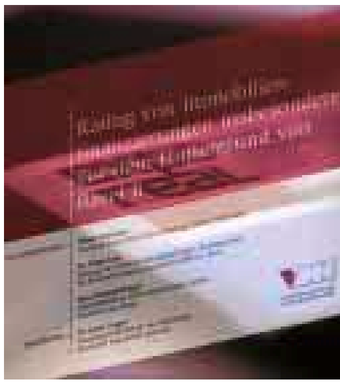
True to the conviction that "there's more to communication than information," dialogue was the center-piece of the classical press work, i.e., press releases, press conferences, interviews and articles. In addition to the annual press conference and meetings with the press in smaller circles, regular individual contacts – in particular on the fringe of events – aimed at creating transparency and building trust by providing facts and background information on the business activities of the mortgage banks. That this was the right approach, especially when dealing with complex topics, was repeatedly borne out by well-presented coverage in domestic and foreign media. The media increasingly sees the Association as point of contact not only for topics relevant to mortgage banks and the Pfandbrief but also for all manner of general questions about the capital markets and real estate.



Media interest undiminished

Media interest in mortgage bank-related topics was undiminished in 2002. An increasing interest by the foreign press in the mortgage banks' lending activities was observed.

Given the tendency that more and more media are complementing articles with visual material, the VDH's graphics service was well received. With topics such as "Pfandbriefe offer more interest," "Secure low-interest, long-term financing now," "High repayment – fast ownership" and "The mortgage rate – it's rarely been lower," 200 clippings or a print coverage of 80 million was achieved.



The VDH issued German-language "Hyp-Meldung" publications dealing with business developments at the mortgage banks, the European code of conduct, the need for improvements with respect to Basel II, the controversial EU Directive on Interest Payments, the mortgage banks' position on Jumbo Pfandbrief buybacks, the question "Corporate governance also in external financing?", the "Riester pension," the introduction of rules of good conduct for the issuance of Jumbo Pfandbriefe, self-imposed restrictions in the investment of available funds, and the draft of the German Tax Law Amendment Act.

Wide range of brochures and publications

To give information about the mortgage banks and their operations, the Association provides an extensive range of materials. The Annual Report and the Pfandbrief Fact Book, which is published yearly in German, English and Japanese and is already into its seventh year, are two of the flagship publications.

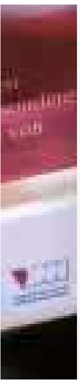
Along the lines of the latter highly successful publication, the first edition of “Real Estate Banking” appeared in October 2002 on the occasion of the EXPO REAL trade fair in Munich. The aim of this fact book, which is published in both German and English, is to draw attention to the core competencies of the mortgage banks in real estate finance and to pick up on current topics concerning all aspects of real estate finance and real estate. Just like the Pfandbrief Fact Book, an annual publication is foreseen that will hopefully advance to become a standard work of reference as well.

New editions of the folder “Association of German Mortgage Banks: Profile, Activities, Structure,” and the “Mortgage Bank Act” were published in the year under review. And in cooperation with the above-mentioned real estate forum in Berlin, an edition of the German-language “ImmobilienSpecial” appeared on the topic “Urban Development in East Germany as a Challenge for State and Business.”

Relaunch of the Internet pages

Communication by e-mail and the Internet is of increasing importance in the day-to-day activities of the Association. The VDH’s homepage was thoroughly revised and expanded during the year under review. In addition to modernizing the design, the relaunch was primarily intended above all to more clearly structure the successively extended range of information on the German and English Internet pages and to make it more user-friendly. Positive feedback and an increase in the number of downloads indicate an enhanced information value for the user.

Also favorably received were the information pages on the Pfandbrief that the VDH placed on the Bloomberg information system, which is accessible worldwide. This system is an excellent way for mortgage banks to reach their target groups.



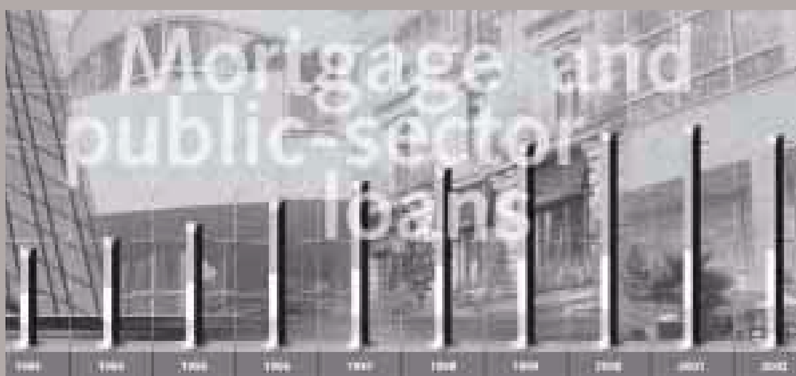
CHRONICLE 2002 +

+ + + **January 22/23** Pfandbrief presentations in cooperation with the IFC in Tokyo + + + **February 21** Basel II – Symposium in cooperation with other urban development associations in Berlin + + + **March 5–7** Lectures and talks in New York and Washington + + + **March 14** Pfandbrief Conference in London + + + **April 16** Annual press conference in Frankfurt am Main + + + **April 24** Pfandbrief Evening in Munich + + + **May 30** 2nd European Pfandbrief Conference 2002 in Brussels + + + **June 10** Member Banks’ Meeting in Hamburg + + + **June 25** Real Estate Forum “Urban Development in East Germany” in Berlin + + + **July 1** Investors’ Seminar in Tokyo + + + **September 10** The thoughts of the VDH presented to experts of the Bundestag parties in Berlin + + + **October 9** Meeting with the press on the “Rules of Good Conduct for the Issuers on the Jumbo Market” in Frankfurt am Main + + + **October 24** Pfandbrief Forum in Gravenbruch + + + **October 28** EXPO REAL Real Estate Forum in Munich: “Basel II and the Property Markets” + + + **November 6** Pfandbrief Conference in cooperation with Institutional Investor in Boston + + + **November 7** 6th Central European Pfandbrief Conference in Warsaw + + + **November 14** Pfandbrief Conference in cooperation with the Börsen-Zeitung in Frankfurt am Main: “The Pfandbrief in the 21st Century” + + + **December 3** Pfandbrief Conference in cooperation with ABN AMRO Bank in Amsterdam + + + **December 5** Annual Reception in Berlin +

+ +

Lending Business of the Mortgage Banks

In line with the very weak economic activity, mortgage and public-sector loan commitments fell once again in the year under review. Particularly commitments for new residential construction (–33%), and in this context primarily the rental housing construction segment (–61%), experienced a veritable collapse due to the poor general conditions and weak demand. Yet commercial property lending also declined (–8.6%), both on the home market (–10.9%) and abroad (–6.6%). The slump in public-sector lending (–18.5%), on the other hand, was due above all to the interest rate environment and funding terms in 2002, which made it difficult to generate profit from this low-margin business.



1 Overview

Development of loan commitments

In the year 2002, the mortgage banks made loan commitments amounting to a total of €113.8 billion. This was €23.7 billion or 17.2% less than in 2001. Public-sector borrowers accounted for €74.6 billion (2001: €91.6 billion) or 65.6% of new lending activity, while €39.2 billion (2001: €45.9 billion) or 34.4% were residential and commercial property loans. Domestic mortgage lending fell by 18.2%, as it now also did abroad by 7.1%. On the German market, fewer residential loans and commercial property loans were extended than in the year before. Domestic residential loans suffered an especially sharp downturn (22.8%) to a volume of €14.9 billion.

Commitments of mortgage and public-sector loans

€ billion	2002	Share in %	2001	Share in %	Change in %
Mortgage loans	39.2	34.4	45.9	33.4	– 14.7
Public-sector loans	74.6	65.6	91.6	66.6	– 18.5
Total	**113.8**	**100.0**	**137.5**	**100.0**	**– 17.2**

Source: VDH statistics

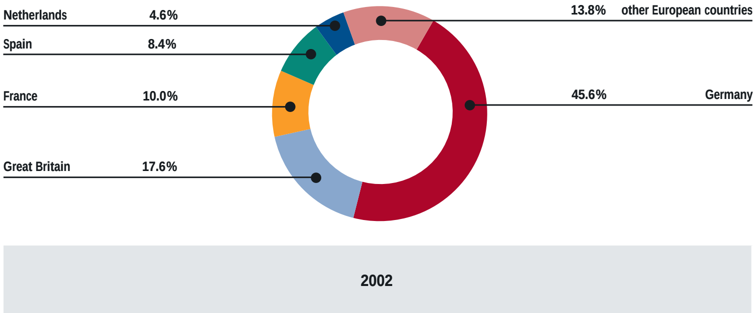
2 Commercial and residential mortgage lending

Overview of commercial property lending in Germany and in Europe

In the year under review, gross fixed capital formation in non-residential buildings dropped in Germany once again, by 5.8% to €91 billion. The unfavorable economic activity affected service undertakings as well as trade so that substantial declines in demand for both office and retail business premises were observed. The positive expectations that existed at the start of 2002 – at least where Western German business construction was concerned – were therefore not fulfilled. Turnover in the main construction trade was consequently down in this sector by 5.5% in Western Germany and by 8% in the new federal states. Nor was the European situation much better. The agencies cooperating within the European advisory network “Euroconstruct” concluded that the Europe-wide construction volume in 2002 was, at best, stagnant versus the previous year. A drop of 3% is expected for 2003, and given its significance within the European context Germany is seen as a brake to Europe’s building sector.

Commercial property finance commitments by the German mortgage banks at home and in Europe fell by 8.6% compared with 2001 to a total of €23.9 billion. Nevertheless, the financing of commercially used properties is still the most important business segment with a 61% share of total mortgage loan commitments. The decline in cross-border lending by 6.6% versus the previous year was below the average rate of decline. This means that despite the Europe-wide slump in building, the mortgage banks were able to consolidate their position as the foremost providers of business construction finance.

Distribution of commercial property finance (commitments) by countries



Source: VDH statistics

Whereas total domestic commercial property loans were, at € 104.6 billion, considerably higher than the European total of € 35.4 billion, the comparison clearly illustrates – in terms of commitments – the present importance of new lending in European commercial property finance. With commitments totaling € 13.0 billion, 54% of all commercial property loans extended in the year under review were cross-border financings. The mortgage banks' continued success in establishing themselves on the European markets, the desire for risk and earnings diversification and the realization of wider margins in foreign operations have helped achieve this high status of the mortgage banks' foreign business activities.

Distribution of commercial lending by properties in 2002

€ million	commercial property loans	share in %	of which new constructions
Property category			
Institute buildings	168.5	0.7	70.0
Office and administrative buildings	15,641.5	65.4	4,042.0
Agricultural buildings	73.2	0.3	21.4
Factory and workshop buildings	374.0	1.6	128.0
Retail buildings and warehouse facilities	6,155.9	25.7	1,829.7
Hotel and restaurants	667.4	2.8	226.9
Other non-agricultural buildings	350.1	1.5	42.9
Other non-residential buildings	404.3	1.7	245.3
Commercial building plots	80.4	0.3	53.3
Total	**23,915.3**	**100.0**	**6,659.6**
of which abroad	*12,991.9*		

Source: VDH statistics

Growing importance of finance for existing buildings

As in 2001, finance for existing properties (purchase, modernization, rescheduling) clearly exceeded finance for new constructions. Loans for existing properties were extended in the amount of €17.3 billion. This is equivalent to 72.1% of all commercial property lending. Financing of existing properties has gained growing importance since the second half of the 1990s. In 1996, the ratio of finance for new constructions to finance for existing buildings was still evenly balanced. New construction financings totaled €6.7 billion, or only 27.9% of the market in the year under review.

Commitments for cross-border commercial property finance

€ million	2002	2001
Belgium	73.0	68.2
Denmark	96.8	33.1
Finland	110.0	26.5
France	2,367.8	1,764.0
Greece	0.0	0.0
Great Britain	4,231.6	6,075.8
Ireland	39.3	0.0
Italy	736.2	136.2
Luxembourg	55.0	19.0
Netherlands	1,103.9	1,824.0
Austria	209.1	192.3
Portugal	269.3	713.1
Sweden	545.8	272.7
Spain	2,047.2	1,310.0
Total EU states	**11,885.0**	**12,434.9**
Poland	197.3	379.8
Czech Republic	152.4	45.1
Hungary	75.8	224.7
USA	385.3	0.0
Switzerland	279.2	812.5
Other states (Norway, Iceland, Liechtenstein)	17.0	14.5
Total commitments	**12,992.0**	**13,911.5**

Source: VDH statistics

Volume of cross-border commercial property finance

€ million	2002	2001
Belgium	464.2	290.3
Denmark	175.1	137.1
Finland	163.9	71.8
France	5,358.0	4,032.7
Greece	0.0	0.0
Great Britain	12,582.2	13,126.7
Ireland	141.1	269.0
Italy	899.2	302.4
Luxembourg	79.5	61.9
Netherlands	5,641.7	5,232.6
Austria	614.4	425.9
Portugal	1,140.3	716.8
Sweden	1,191.8	784.7
Spain	3,712.6	2,972.5
Total EU states	**32,164.0**	**28,424.4**
Poland	471.9	282.3
Czech Republic	216.3	89.0
Hungary	170.4	161.1
USA	379.7	0.0
Switzerland	1,774.0	1,657.5
Other states	197.6	158.8
Total volume	**35,373.9**	**30,773.1**

Source: VDH statistics

Predominant market position of the mortgage banks

According to Deutsche Bundesbank figures, the volume of commercial property loans extended by all banks operating in Germany was €232.7 billion as at year-end 2002 (2001: €223.6 billion). For years, the German mortgage banks have held by far the largest market share (43.8%), with a loan book of €101.8 billion.

Residential property finance

In residential property finance, the mortgage banks secured for themselves, with €233 billion, a market share of 21.8% (2001: 22.5%). Thus the mortgage banks are still Germany's second-largest residential financiers after the savings banks, which lead the market with aggregate lending of €290 billion or a market share of 27.1% (26.8%). The cooperative banking sector ranks third with a volume of €165 billion, which is equivalent to a market share of 15.4% (15.0%).

3 Public-sector lending

Perceptible decline in public-sector loan commitments – further expansion of commitments abroad by 2.8%

In 2002, the mortgage banks granted public-sector loan commitments totaling €74.6 billion, 18.5% less than one year before. Commitments to domestic public authorities amounted to €25.8 billion, falling 25.9% short of the previous year’s level.

The total volume of public-sector lending to central, regional and local authorities in member states of the EU and the EEA was €55.6 billion (55.4) accounted for, above all, by Italy (€13.9 billion), Austria (€9.9 billion) and Spain (€7.6 billion).

Commitments for EU public-sector loans compared with the previous year

€ million	2002	2001
Belgium	940.0	902.8
Denmark	0.0	0.2
Finland	120.8	40.0
France	774.7	564.8
Greece	672.6	2,547.3
Great Britain	241.7	621.2
Ireland	77.3	342.1
Italy	3,355.2	4,809.0
Luxembourg	15.0	25.0
Netherlands	1,284.6	1,940.0
Austria	4,009.8	1,703.6
Portugal	1,143.6	871.4
Sweden	142.7	108.4
Spain	1,994.9	1,529.9
Total	**14,772.9**	**16,005.8**

Source: VDH statistics

Amendment and Modernization of the Mortgage Bank Act

The amendment of the Mortgage Bank Act (HBG) took effect on July 1, 2002. Through it, broadly speaking, the sphere of business open to mortgage banks was moderately enlarged, while the quality of the Pfandbrief was enhanced by the possibility to include derivatives in cover pools and the introduction of the present-value calculation of cover. Yet the Association of German Mortgage Banks has still not reached its ultimate objective. Work is currently under way on new provisions aimed at underscoring the Pfandbrief's benchmark status on the covered bond market.

The amendment of the Mortgage Bank Act came into force on July 1, 2002, as part of the 4^{th} Financial Market Promotion Act. The following provides a recap of the main points and takes a brief look at actions to implement the amendment and supporting measures.

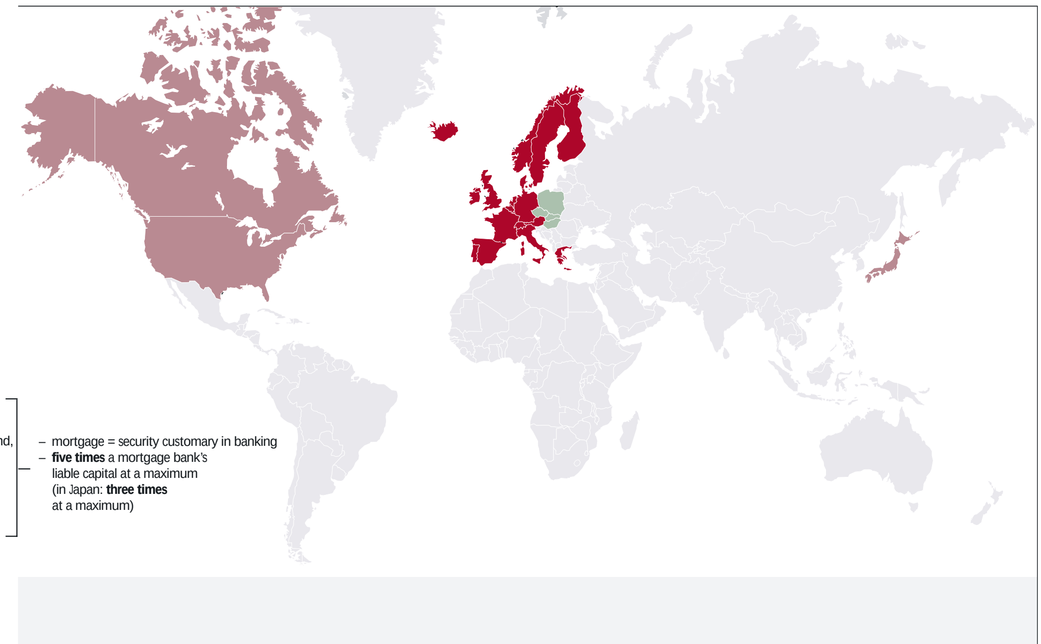
Sphere of operations widened by the amendment 2002 of the Mortgage Bank Act

Amendment of the Mortgage Bank Act safeguards the mortgage banks' future

The business activities open to mortgage banks as institutions specializing in public-sector lending and real estate finance are governed by the German Banking Act (KWG) and the strict limitations set down in the Mortgage Bank Act (HBG). This is why the alignment of the legal framework specific to mortgage banks to the rapidly changing demands of the market is of outstanding importance to safeguard the competitiveness of these institutions. Within the scope of the 4^{th} Financial Market Promotion Act, an amendment of the Mortgage Bank Act also came into effect on July 1, 2002. This amendment marks an important step towards safeguarding the mortgage banks' future. Besides expanding their sphere of activities, it gives a further boost to the Pfandbrief's quality and includes a number of provisions that primarily facilitate the practical handling of international operations.

The mortgage banks, whose lending activities were previously confined to the member states of the EU, the European Economic Area and a number of Central European reforming countries, are now permitted to grant loans to sovereign and sub-sovereign authorities in the US, Canada and Japan. Whereas public-sector loans may be refinanced through Pfandbriefe, the HBG does not envisage this possibility for mortgage loans. What is more, real estate loans in

Expansion of mortgage lending



business within the cover to date:
EU, EEA, Switzerland

business outside the cover to date:
further European OECD countries (Poland, Czech Republic, Slovakia, Hungary)

business outside the cover:
USA, Canada, Japan

these countries – together with non-Pfandbrief refinanceable property loans in Poland, Slovakia, the Czech Republic, and Hungary – are limited to five times a mortgage bank's regulatory capital; in Japan, mortgage lending is restricted to three times a bank's capital.

Addition of property-related services strengthens customer ties

To the mortgage banks, permission to offer an extensive range of services related to property finance and public-sector lending was a matter of increasing importance. Previously, they were allowed to engage only in auxiliary operations linked to lending business, but since the amendment the following services may be offered as a source of income in their own right, i.e. without actually being connected to a financing transaction: administration of mortgage and public-sector loans, real estate brokerage, valuations and location studies, financial advisory services including advice in connection with securitization transactions, and investment counseling including the structuring of real estate assets.

Besides the changes outlined above, the HBG amendment brought with it a number of other new provisions that were dealt with in the 2001 Annual Report (cf. pp. 34).

Inclusion of derivatives in cover pools gives Pfandbrief quality a further boost

Under last year's amendment, the HBG contains for the first time provisions that make derivatives permissible in principle. Permitted are all derivatives that are connected to a mortgage bank's core activities. However, no open short positions or similar risks may be entered into.

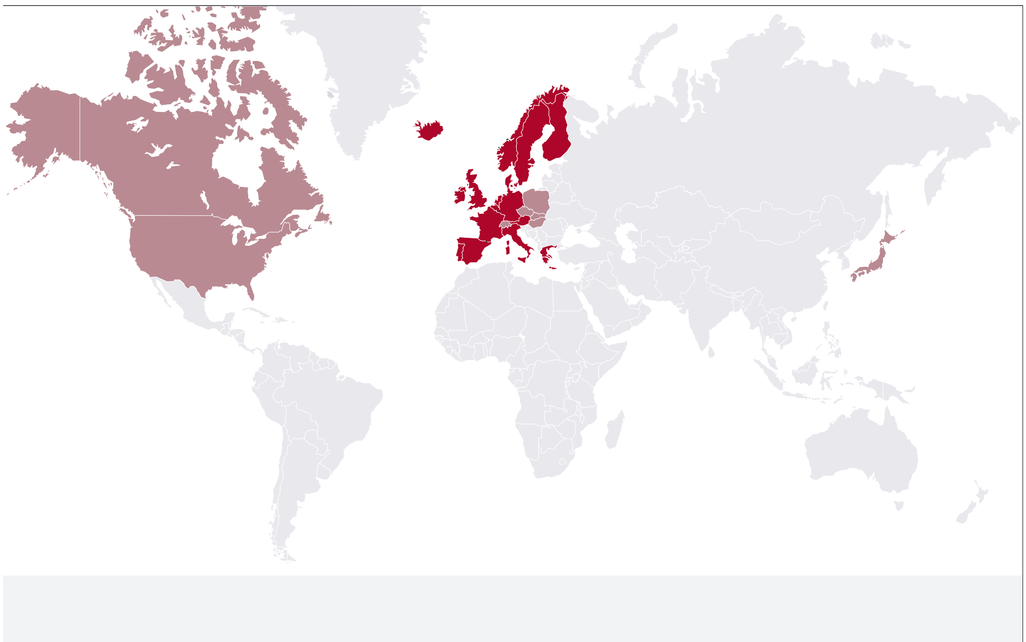
The HBG amendment 2002 expressly stipulates that mortgage banks may include derivatives in their cover pools, which means they are placed under the protection of the trustee. For insolvency law purposes, the derivative counterparties rank equally with Pfandbrief creditors. The banking associations have drawn up an annex to the German master derivatives agreement stating in detail the regulations governing the inclusion of derivatives in cover.

Expansion of public-sector lending

business within the cover to date: EU, EEA
new: expansion to include non-profit organizations

new business within the cover: Switzerland, USA, Canada, Japan (incl. regional goverments and local authorities)

further European OECD states (central governments only: Poland, the Czech Republic, Slovakia and Hungary



The volume of derivatives eligible for cover is limited to a maximum of 12% both of the Pfandbriefe outstanding and of the cover pool. Market observers including analysts and rating agencies unanimously agree that the inclusion of derivatives in cover further strengthens the quality of the Pfandbrief. Last year's Annual Report already took a closer look at the inclusion of derivatives in cover (cf. pp. 35).

Calculation of present-value cover

A further provision of the amendment is that in addition to nominal cover, previously the sole criterion, net present-value cover must also exist for Pfandbriefe at all times. Thus, even in the event of a mortgage bank's insolvency, the cover funds would be effectively protected against interest rate and currency risks. Suitable yield curves and recognized procedures commonly applied in practice must be used when calculating the present value. Moreover, stress scenarios are to be taken into consideration to assure present-value cover also in the event of strong market fluctuations. The Association of German Mortgage Banks (VDH) discussed with the Federal Authority for Financial Services Supervision (BaFin), over a period of months, the details of the procedure to be applied. The Federal Ministry of Finance has since exercised its authority and transferred powers to the BaFin to issue a regulation stipulating the details of the present-value calculation method and the measure of interest rate and exchange rate changes the cover must withstand. It is expected that the official draft of this regulation will be completed shortly. There are already signs that the demands made of the cover calculation will far exceed the so-called Gentlemen's Agreement to restrict interest rate risk.

With modernization in mind, the Association is working on a concept for a new Mortgage Bank Act. The reasons that prompted these efforts and the concept's key content are described below:

Reasons for modernizing the HBG

Pure and mixed mortgage banks

In line with consolidating and restructuring the mortgage banking industry, the market share secured by the mixed mortgage banks has risen substantially. The rule-exception ratio between pure and mixed mortgage banks has been disturbed. From the pure mortgage banks' viewpoint, therefore, it is essential to restore a level playing field in competition. The restrictions the HBG imposes on pure mortgage banks' business activities need to be completely reassessed. The mortgage banks represented by the Association are aware of this development and are seeking suitable solutions which on the one hand take the interests of the parties concerned into consideration and the requisite safety of the Pfandbrief on the other.

Public-sector credit institutions as Pfandbrief issuers

Mortgage banks are not the only Pfandbrief issuers. In 1927, the legal framework was created governing the issuance of Pfandbriefe by public-sector institutions, namely the Act relating to Pfandbriefe and Similar Instruments issued by Public-Sector Credit Institutions (ÖPG). The main difference between the ÖPG and HBG is that the former contains no restrictions on the business activities of the issuers. The HBG was not made to apply to public-sector issuers because, among other things, of the official character of these institutions. However, the unstated grounds for this were probably also the state support mechanisms in place for these issuers' obligations. Moreover, the public-sector banks were engaged in significantly narrower fields of operation than they are today, and were subject to additional legal regulations of the individual federal states (Länder). The support and guarantee mechanisms mentioned above will, however, cease to apply as from 2005. The structural changes this will bring to public-sector banking are complex and are not yet fully apparent. But it is clear that the renouncement of the pulic-sector legal form will also result in the loss of the right to issue Pfandbriefe. Obviously, then, given these developments action is needed to reshape the legal framework for public-sector Pfandbrief issuers.

Safety and competitive strength of the Pfandbrief are top priority

Pfandbrief as pillar of German long-term financing

The Pfandbrief serves as a credit benchmark of the European capital market. As such, it is a reference for the entire bond market, and one of the most important assets of the German financial center. Further, the Pfandbrief is one of the main pillars of Germany's traditional "culture of long-term financing." The strict legal requirements governing the issuance of Pfandbriefe and valuation as well as the stringent cover requirements add up to an exceptionally safe system that offers investors an incentive to make their funds available on a long-term basis. This enables the mortgage banks to lock in their interest rates for loans on a long-term basis and also gives borrowers a reliable basis when planning their principal repayments. The advantage of this "long-termism" is demonstrated, for example, by the low volatility level of the German property market compared with those elsewhere.

In addition, funding through the capital market enforces, generally speaking, a risk-adequate pricing also on the credit market. After all, refinancing through Pfandbriefe makes it possible to transfer relatively small and illiquid loans that – subsequently – are generally unsuitable for tapping the capital market into liquid Pfandbrief issues and, with that, into marketable tranches. Competition among the institutions guarantees that – in contrast to other funding systems – these inexpensive and risk-adjusted capital market rates are passed on to the borrowers.

HBG secures competitve solution

A glance abroad, where real estate finance and public-sector lending is often state-subsidized, confirms the strong interest of the public authorities in assuring these sectors are suitably equipped with finance capital. Yet there are differences in the way this objective is pursued in individual countries. By introducing the HBG, German legislators opted for a decentralized, competition-based solution. What favors the competitive solution with its stringent legal framework is the fact that the funding advantage gained through the Pfandbrief is not dependent on a state guarantee or other state aids.

One thing is clear: The Pfandbrief and its first-rate quality will not be compromised on. On the contrary, the quest for further improvement will continue wherever possible. At the same time, the radically changed market environment makes it necessary to adjust the business activities open to mortgage banks. It is between these two stances that thought must be given to the ongoing development of the Pfandbrief system.

Specialist bank principle essential to the quality of the Pfandbrief

Besides the exacting coverage rules stipulated by the HBG, the specialist bank principle – which is to say the restriction of mortgage banks' operations – is central to the safety of the Pfandbrief. The idea at the heart of this principle is to ensure that the Pfandbrief issuers are not affected by risks that do not result from property finance and public-sector lending.

Specialist bank principle strengthens the Pfandbrief

For one thing, confinement to a small number of business fields forces the mortgage banks to develop specific expertise, cost-efficient structures as well as flexible and fast decision-making processes. This professionalism benefits the quality of the cover pools and, with that, the safety of the cover assets. Because they specialize, the policy orientation of mortgage banks is not only to use the Pfandbrief as a refinancing instrument but also to strengthen it within and outside the cover pools through a circumspect lending policy, and to develop the capital market for Pfandbriefe. At the same time, the restrictions imposed on mortgage banks' activities make it easier to conduct the special supervision to which the issuers are subjected. This is key to the Pfandbrief's high credit standing. Specialization reduces the complexity of the institutions and operations to be supervised.

The optimal realization of the basic idea behind the Pfandbrief system – to use the capital market to fund property and state investments – presupposes a high degree of homogeneity of the issuers and their issues. This is to be achieved only by concentrating on core activities within a uniform legal framework. Not to be underestimated in this context are the mortgage banks' innovative prowess and speed of innovation. The fact that they share the same interests has enabled them to constantly develop the Pfandbrief and promote it worldwide. Thus, maintaining the specialist bank principle is a necessary precondition for investor confidence in the safety of the Pfandbrief.

Central features of a modernized HBG

Detailed insolvency rules called for

The disappointing spread developments the Pfandbrief market is experiencing at present are an indication that certain provisions of the HBG are not sufficiently clear to secure investor confidence in a uniform quality of the Pfandbrief. For this reason, the weak points of the German Pfandbrief system being discussed in this context are at the heart of thoughts the mortgage banks are devoting to revamping the HBG.

According to the changes under discussion, in the event of a mortgage bank's insolvency an asset pool administrator would be appointed to actively administer the cover assets. The personnel and material costs for this administration would be paid for out of a legally stipulated overcollateralization. Further, the possibility to transfer the cover pools in their entirety or in part and the respective Pfandbriefe and derivatives to another legal entity would be anchored in law. Moreover, the increasing complexity of lending within the cover limit, as demonstrated by the present-value calculation of cover and the possibility to include derivatives in cover, necessitates minimum qualifications which a trustee must have. In addition, trustees should be granted more extensive powers of examination so that they can fully perform their task.

The concept of the mortgage lending value is a core element of the safety of the Mortgage Pfandbrief; according to the mortgage banks, it should in future be bolstered by including detailed provisions in the Mortgage Bank Act.

Redefining the "specialist bank principle"

Thus, many arguments show that the fathers of the HBG created the right basis for the Pfandbrief system with the specialist bank principle. The existence of sufficient earnings potential – also in a changed market environment – is a crucial prerequisite for the soundness of a credit institution. On the one hand, the mortgage banks' specialization curbs this potential. On the other, the safety aspects that have been mentioned speak in favor of specialization. The objective must be, therefore, to strike a balance between these two aspects.

Today, the HBG lists the activities mortgage banks are permitted to engage in and the assets eligible as cover. The image the mortgage banks have of themselves in the 21st century, however, is essentially that of specialist banks for property and public-sector finance. This is why they advocate having the specialist bank principle – with Pfandbrief issuers specializing, in a general sense, in property and public-sector finance – anchored in the HBG.

To preserve the high level of safety embodied in the Pfandbrief it is important to apply particularly stringent standards to business refinanced through covered bonds. For this reason, in the view of the mortgage banks, both property and public-sector lending refinanced through covered bonds should be restricted to the countries of the European Union, the European Economic Area as well as the non-European G7 states. It also makes sense to consider bonds such as Mortgage Backed Securities (MBS) and Pfandbriefe as well as investment fund units as cover assets up to a maximum limit of 20%, provided at least 90% of the underlying assets stem from transactions eligible for cover.

No desire for general commercial banking licence

The broader definition of the business fields property and public-sector finance would give mortgage banks the flexibility they need to market their core competences in a customer and earnings-oriented way. Besides financing expertise, these include services closely linked to property and public-sector finance, which for this reason ought to be permitted in their own right. A business model refined along these lines, according to which mortgage banks see themselves as universally specialized real estate and public-sector finance banks, is still compatible with what the specialist bank principle stands for, i.e. the restriction of business operations. The safety of the Pfandbrief will not be impaired by this new definition, especially since weaknesses in Pfandbrief law affecting safety are also to be remedied at the same time. In essence, the amendments outlined here would augment the mortgage banks' leeway and flexibility in adapting to changes in their competitive environment. They would then be able to respond to constantly changing demands, to tap the earnings potential that becomes available due to their specialist expertise and to secure their earning power on a long-term basis.

European Policy Aspects of the Mortgage Banking Business

On December 13, 2002 the European Council of Copenhagen concluded negotiations with the ten EU admission candidates Estonia, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, the Czech Republic, Hungary and Cyprus, and reached an historic decision by making these countries a binding offer to join the European Union as at May 1, 2004.

For the European financial market, the consequence of EU expansion and the swift pace of the integration of financial and capital markets is the need for further adjustment.

With a financial market reform based on accelerated legal proceedings, the European Commission and the EU member states are now trying to further safeguard the competitiveness of the EU.

Shortly before the end of 2002 the EU Commission presented the 7th progress report on the implementation of the Financial Services Action Plan. Of a total of 42 measures, 31 were finally realized including, in the year under review, the International Accounting Standards Regulation, the Directive on Financial Collateral, the Distance Selling Directive, the Directive on Insurance Mediation and the Financial Conglomerates Directive. The Council reached a Common Position regarding the Pension Funds Directive. Nevertheless, competitive restrictions persist in the financial services sector. The EU Commission estimates that as a result of a further integration of the financial markets the real GDP of the EU would rise by some 1.1% and overall employment by some 0.5%. Besides working on a new Investment Services Directive, the implementation of Basel II in the EU is currently the main focus of the Commission bodies' activities.

1 Implementing Basel II in the EU

With the aim of making accessible to the banking community in good time the main contents of the third EU consultative paper on the future capital adequacy regulations for banks in the EU – expected in early summer 2003 – the EU Commission published an extensive working document on November 18, 2002. This paper shows that the Commission is still pursuing the strict objective of implementing Basel II EU-wide, simultaneously and with uniform contents. The progress made in Basel for mortgage lenders so far has largely been endorsed by the EU Commission, and the compromise reached by the Basel Committee on the maturities-related component will also be accepted.

However, the content of the working document concerning the mortgage loan is of a general nature; it contains no concrete provisions. The EU Commission has announced that it will publish a special discussion paper on the mortgage loan in spring 2003, which will then be included in the third EU consultative paper. But the following general principles are discernible at present:

Treatment of the mortgage loan

EU capital adequacy requirements for the mortgage loan proceeding well ...

The EU Commission makes a great effort to achieve consistent definitions of housing and commercial property loans across all weighting approaches. It is pleasing to note that under the modified standardized approach the 40% weighting of real estate-secured home loans that has been agreed on in Basel as well as the option for the 50% weighting of the commercial real estate loan are to be accepted. Also to be welcomed is the intention not to anchor in EU law the special conditions (strict exclusion criteria, hard tests, etc.), stated by the Basel Committee in the so-called "criteria paper," for the preferred weighting of the commercial mortgage; instead, for reasons of practicability, recourse will be taken to the hitherto valid regulations of the Solvency Ratio Directive.

In return, however, the EU Commission intends to impose so-called minimum requirements that must, as a general principle, be met by all mortgage loans to receive a preferred weighting under the modified standardized approach or to be recognized as collateral under the internal ratings based approach.

… yet danger exists of inferior status for income-producing property

There are signs that issues concerning the value of real security, the valuation of the property and the re-valuation of property on a regular basis during the life of the loan as well as requirements with regard to insuring the property being financed are likely to be regulated. Especially problematic is the removal, under consideration by the EU Commission, of the commercial income-producing property from the 50% weighting under the standardized approach and recognition as collateral under the ratings based approach if the borrower is largely dependent on the income from the property to repay the loan and has no other earnings at his disposal. The Association of German Mortgage Banks (VDH) explicitly rejects such a lower ranking.

With respect to the foundation internal ratings based (IRB) approach, the EU Commission is unlikely to accept the possibility granted by the Basel Committee to introduce an equity cap of 3.9% for commercial mortgages. Under Basel II, such an upper limit may be set by the supervisory authorities of countries which permit the 50% weighting for commercial property loans under the standardized approach to safeguard consistency between the two approaches and give banks an incentive to switch to the ratings based approach. Since, on the basis of an LGD rate reduced to a maximum of 35%, the equity weighting for commercial property loans rises to more than 75% under the foundation IRB approach, this approach must be deemed unattractive for VDH member institutions.

The weighting of Pfandbriefe

Whereas support for the retention of the 10% weighting for Pfandbriefe is gaining ground in the EU for the modified standardized approach, no adequate solution has to date been found for the treatment of Pfandbriefe under the internal ratings based approach. The Commission intends to use the risk weighting function applied to banks and companies, and based on probability of default (PD) and loss given default (LGD), for Pfandbriefe as well.

IRB approach unsuitable for Pfandbriefe on PD and LGD basis

Yet this methodology is not compatible with the risk profile of the Pfandbrief. The aim behind the legal framework of the Pfandbrief and of the other Pfandbrief-similar products in Europe is, after all, to separate the Pfandbrief creditors' interests from the fate of the issuer by separating the cover pools from the rest of the bank. Thus, the capital backing for Pfandbriefe cannot be made to depend on the probability of default, i.e. on the creditworthiness of the issuer.

Instead, given its special legal basis, the Pfandbrief can only be classified as a unique type of bond and the application of the blanket Pfandbrief weighting of a maximum of 10% called for under the modified standardized approach must also be permitted under the internal ratings based approach (partial use). The European Mortgage Federation supports this view, and is pressing the European Commission to comply.

As far as other bonds by Pfandbrief issuers are concerned, there is a danger that these may not be treated equally with other bank bonds of other issuers. The justification given for this is that the quality of the uncovered bonds must automatically be poorer than that of bank bonds of non-Pfandbrief issuers because of the privileged status given to the covered paper. Yet studies have shown that the default rates of mortgage banks' lending activities outside the cover limit are low, and that a not inconsiderable part of lendings outside the cover limit comprises loans secured by a first mortgage.

Partial use

One important demand being voiced by the mortgage banks is that a permanent partial use of the rating procedures be granted both at group and at portfolio level. Compared with the restrictive regulations envisaged by the Basel Committee on partial use, somewhat greater leeway appears likely in the EU inasmuch as a permanent partial use of the procedures will be permitted in the balance sheets of small and medium-sized banks for immaterial credit risks or those of little consequence as well as for bank and sovereign risks, provided the number of banks and sovereigns is kept small.

The mortgage banks feel that the scope of this regulation is insufficient given the European banking structure. A permanent partial use must be possible for all group companies within a banking group irrespective of the size of the bank and its geographical field of activity. Otherwise, external strategic considerations could lead to a bank being denied access to the approach most favorable for it. It must also be possible to apply partial use to clearly separable portfolios at bank level. This must be the case, above all, when an internal ratings based approach would be too work-intensive in light of the risk relevance of the assets or if a validation of the rating approach appears impossible due to a lack of default or loss histories. In these cases, the possibility of cherry-picking – which the ban on partial use is intended to prevent – has to be ruled out.

Partial use necessary at group level and for clearly separable portfolios

2 EU capital market

Efforts to further integrate the European securities markets culminated at end-2002 in the resolution of the Market Abuse Directive. After all, progress was made with the Directive on Prospectuses. Initial experiences with the so-called Lamfalussy process give, however, cause for ongoing criticism.

Directive on Market Abuse

The Directive on Insider Trading and Market Abuse was formally passed by the Council on December 3, 2002. With it, a framework directive was for the first time resolved in accordance with the Lamfalussy process whereby the directive stipulates only the basic principles; the technical details, on the other hand, will be set out in implementing provisions that the Commission resolves under the supervision of the European Securities Committee (ESC) on what is known as “Level 2.” The Commission is advised by the “Level 3 Committee” of the Committee of European Securities Regulators (CESR).

The directive strengthens the integrity of the securities markets in the EU and gives a boost to the fight against market abuse and insider trading. One point that has been achieved is that practices usual in the market such as price support for Pfandbriefe and market-making do not constitute market abuse.

Directive on Prospectuses

After the EU Commission presented an amended proposed directive in August 2002, the ECOFIN Council was able to reach a political agreement over the wording of the directive in November 2002. The Council succeeded in combining investor protection and market flexibility by way of a compromise. The forthcoming second reading by the European Parliament will concern primarily the question whether the bond issuer’s right to choose the authority responsible for the issue should be limited or not.

The currently existing exemption of tap issuers from the requirement to prepare a prospectus was untenable. However, an easing of the requirements seems to be in sight for tap issuers of Pfandbriefe inasmuch as only a basic and simplified prospectus instead of a full prospectus would have to be produced, which could be conceived as an issuer-related prospectus. In line with our demand, such a prospectus would not be prepared for each individual issue but once only, and updated annually. Investors would then receive information on the individual issue and add-ons in the form of the condensed final terms. The technical details, however, still have to be approved by the CESR.

Yet the scope of the exceptional rule is unsatisfactory. For the second reading in the European Parliament the Association submitted the demand that the loosening of the prospectus requirements be extended to all securities issued by banks as tap issuers so that uncovered bonds are also included.

Based on first experiences with the Lamfalussy process, the VDH is critical of the absence of transparency which the EU Commission had promised. One particular problem is that the consultation procedure with market participants was conducted at a time when the final wording of the directive had not yet been established. Moreover, the dates for consultations will have to be announced in good time and sufficient notice given to allow for comments. Also, the dates must be organized in such a way that all market participants are able to attend the hearings. And finally, languages other than English should be admitted as written and negotiating language.

International Accounting Standards (IAS)

In June 2002, the Council adopted the proposal for a regulation on the application of IAS submitted by the EU Commission on February 13, 2002 following the European Parliament's positive vote. The regulation has been valid law in all member states since September 11, 2002 and compels approx. 7,000 listed companies in the EU – including banks – to draw up their consolidated annual accounts in line with International Accounting Standards as from 2005. EU member states have the possibility to extend the sphere of application of the regulation to non-listed companies and the presentation of separate accounts.

A regulatory committee comprising representatives of the member states and led by the EU Commission must approve the IAS within the EU, and for this purpose is advised by the European Financial Reporting Advisory Group (EFRAG), which is composed of experts from the private sector.

The introduction of the fair value is intended to make annual accounts comparable EU-wide, benefiting competition and the free movement of capital. The implications of this new approach for the balance sheets of banks have, however, not been conclusively examined. It cannot be ruled out that a pure fair value approach will increase the volatility of bank balance sheets, jeopardizing the stability of the financial markets. Studies on this issue by EFRAG are underway, while at the VDH a working group has been set up to deal specifically with the topic of accounting by IAS.

Valuation in a State of Change

Systemizing and improving the methodological principles is making ever greater headway in valuation. Particularly worthy of note is the work being done to bring together the various provisions on valuation for real estate loans pursuant to §§ 11 and 12 Mortgage Bank Act (HBG) within the scope of specimen valuation instructions and the development of a standardized risk measurement system for real estate, known as the “property and market rating.”

Expansion of the valuation spectrum

The demands made of property valuation in the banking industry are becoming more and more diverse. Issues such as risk and portfolio management are moving increasingly to the fore. Besides the international establishment of the mortgage lending value (MLV) as a value-at-risk approach, intensive work is therefore being devoted to a property and market rating based on the market value.

Property and market rating

Transparency and comprehensibility in property ratings

In the year under review, the VDH's Committee for Valuation Matters advocated the creation of joint criteria to promote transparency and comprehensibility in property ratings. A detailed concept for a property and market rating is currently being developed. Besides the hitherto customary quantitative assessment made of the property using nominal values (MLV and market value) a qualitative assessment of the property and of the risks it entails will also be possible.

The property and market rating is intended to simplify the portfolio management by banks and other market participants, improve credit and risk analysis and support the rating systems for Basel II. "Property and market rating" presentations that have been given at national and international level demonstrate the great interest.

International valuation

The initiatives developed by the Association of German Mortgage Banks at national level to improve the quality of valuations have often given the impetus for international developments as well. This is especially true of the proposals concerning portfolio valuations and the property and market rating.

The European Group of Valuers Association (TEGoVA)

The VDH has been represented on the Board of the TEGoVA since early 2002. In this function it has also assumed responsibility for coordinating the German TEGoVA delegation. This underlines the VDH's commitment at the European level and demonstrates the significance of foreign activities for the German mortgage banks.

Valuation of property portfolios

Also early in 2002, the "Securitization" group of experts led by the VDH presented its recommendations on the valuation of real estate portfolios, which were included as a Guidance Note in the new edition of the European Valuation Standards EVS 2003. In future, a detailed property risk profile will be available to valuers for individual properties and property portfolios to enable them not only to determine portfolio values on the basis of concrete current values and MLVs of the properties, but also to make well-founded appraisals of the opportunities and risks of the respective portfolio and the properties it contains. At the same time, with the possibility to calculate the MLV of a property portfolio, the preconditions for the purchase and the inclusion in cover of Mortgage Backed Securities by mortgage banks is also to be created.

A further TEGoVA group of experts is devising, along the lines of the VDH initiative, recommendations for a European property and market rating. Here, too, the aim is to flesh out the criteria of the risk/reward profile conceived for the portfolio valuation, i.e. to achieve a concrete valuation of the property and its market.

European Mortgage Federation

The quality initiative by the VDH has been joined by the European Mortgage Federation. Leading real estate financiers in Europe take the view that the risk/reward profile of properties accepted as collateral must be rendered more transparent in valuations. In consequence, the two organizations have agreed on one property risk profile – the core elements of which are identical to the TEGoVA and VDH criteria – and adopted it as a guideline for property valuers Europe-wide.

In taking this step, the European mortgage lenders have not only acknowledged the course taken by the TEGoVA as correct but have also given substance to the value-at-risk approach underlying the calculation of the MLV.

International Valuation Standards Committee (IVSC)

New Standard Committee at the IVSC

In September 2002, chairmanship of the IVSC switched by rotation from Australia to the Royal Institution of Chartered Surveyors (RICS). This change coincided with the decision by the IVSC Board of Directors that in future the IVSC would concern itself purely with standard-setting and leave all other activities such as the worldwide implementation of the standards or the improvement of professional and advanced training measures to the member associations and the newly founded “WAVO World Association of Valuation Organizations.” Moreover, the “Standard Sub-Committee,” which was previously concerned with drafting the International Valuation Standards (IVS), was upgraded with the creation of a new “Standard Board.” Germany does, however, not have a seat on the Standard Board, since Europe is represented through the RICS and the Romanian Valuers Association.

The IVSC believes the setting of International Valuation Standards (IVS) to be the prerogative solely of the IVSC and that regional organizations such as the TEGoVA cannot be granted standard-setting powers. This means that the TEGoVA would have to discontinue its activities in favor of European Valuation Standards (EVS) and act to ensure that the IVS are implemented in Europe as well. Yet the TEGoVA feels unable to renounce European standard-setting powers. The RICS on the other hand, has as a national association been the most outspoken advocate of the IVS so far and inserted the “Open Market Value” in the new “Red Book” and declared that solely the IVS should be used in international business.

The IVSC and TEGoVA are convinced that the cooperation between both organizations must be developed further. In the past, this took place through the “Securitization” groups of experts that worked in parallel to one another. This is to be continued in future with the property and market rating. Further, the IVSC offered the TEGoVA a seat on the Standard Board.

Hyp Zert GmbH

Number of Hyp Zert experts growing steadily

Also in the year under review, the Hyp Zert held numerous examinations in the categories valuer for mortgage lending valuations, market valuer and residential property valuer. A total of 382 property valuers are now certified. In 2002, mortgage lending valuation accounted for 55 first-time certifications and 55 re-certifications. In all, 44 valuers became certified market valuers in the year under review; moreover, the title “valuer for residential properties” was awarded for the first time, with 32 recipients.

In 2002, Hyp Zert GmbH again organized advanced training events for property valuers in the following fields:

- Aspects particular to the valuation of special-purpose properties
- European property markets and their valuation procedures – Austria, Italy, Switzerland
- Geo-data-related services in e-business for banks (in cooperation with the InGeoForum)
- DCF procedure in property valuation

Foundation of Hyp Zert e.V.

An expansion of the range of services provided by Hyp Zert is currently under consideration. In order to formally present these thoughts, the Association of German Public Sector Banks (VöB) and the VDH have together filed an application with the German Association for Accreditation (TGA) to set up a new sectoral committee for property valuation and analysis for banking purposes. If the application is approved, greater flexibility could be achieved in future certifications for banking purposes, such as for the market value or for the property and market rating. Just how economically feasible and appropriate such concepts are is currently being examined by the supervisory board of the Hyp Zert GmbH.

In view of enhancing the exchange of experience between certified valuers, the Hyp Zert e.V. was founded in 2002. As at December 31, 2002, the Hyp Zert e.V. already had 381 members. Specialist topics are discussed in depth by six regional groups, thus fostering qualification and communication between valuers.

Member Institutions

Allgemeine HypothekenBank Rheinboden AG
Bockenheimer Landstrasse 25
60325 Frankfurt am Main
GERMANY
Telephone + 49 69 7179-0
Telefax + 49 69 7179-100
Internet: www.ahbr.de

Bayerische Hypo- und Vereinsbank AG
Am Tucherpark 16
80538 München
GERMANY
Telephone + 49 89 378-0
Telefax + 49 89 378-6103
Internet: www.HypoVereinsbank.de

Berlin-Hannoversche Hypothekenbank AG
Budapester Strasse 1
10787 Berlin
GERMANY
Telephone + 49 30 2599-90
Telefax + 49 30 2599-9131
Internet: www.BerlinHyp.de

Deutsche Genossenschafts-Hypothekenbank AG
Rosenstrasse 2
20095 Hamburg
GERMANY
Telephone + 49 40 3334-0
Telefax + 49 40 3334-1111
Internet: www.dghyp.de

Deutsche Hypothekenbank (Act.-Ges.)
Georgsplatz 8
30159 Hannover
GERMANY
Telephone + 49 511 3045-0
Telefax + 49 511 3045-459
Internet: www.deutsche-hypo.de

Dexia Hypothekenbank Berlin AG
Charlottenstrasse 82
10969 Berlin
GERMANY
Telephone + 49 30 25598-0
Telefax + 49 30 25598-200
Internet: www.dexia.de

Düsseldorfer Hypothekenbank AG
Berliner Allee 43
40212 Düsseldorf
GERMANY
Telephone + 49 211 86720-0
Telefax + 49 211 86720-209
Internet: www.duesshyp.de

Eurohypo AG
Taunusanlage 9
60329 Frankfurt am Main
GERMANY
Telephone + 49 180 34976-00
Telefax + 49 180 34976-88888
Internet: www.eurohypo.com

HKB Hypotheken- und Kommunalkredit-Bank AG
Am Söldnermoos 17
85399 Hallbergmoos
GERMANY
Telephone + 49 89 607695-0
Telefax + 49 89 607695-81
Internet: www.hkb-hyp.com

HVB Real Estate Bank AG
Von-der-Tann-Strasse 2
80539 München
GERMANY
Telephone + 49 89 2880-0
Telefax + 49 89 2880-10228
Internet: www.hvbrealestate.de

Hypothekenbank in Essen AG
Gildehofstrasse 1
45127 Essen
GERMANY
Telephone + 49 201 8135-0
Telefax + 49 201 8135-200
Internet: www.essenhyp.com

Karstadt Hypothekenbank AG
Theodor-Althoff-Strase 7
45133 Essen
GERMANY
Telephone + 49 201 727-7575
Telefax + 49 201 727-7580
Internet: www.karstadthyp.com

Münchener Hypothekenbank eG
Karl-Scharnagl-Ring 10
80539 München
GERMANY
Telephone + 49 89 5387-800
Telefax + 49 89 5387-900
Internet: www.muenchenerhyp.de

SEB Hypothekenbank AG
Weissfrauenstrasse 10
60311 Frankfurt am Main
GERMANY
Telephone + 49 69 92048-0
Telefax + 49 69 92048-333
Internet: www.SEBhyp.de

M.M.Warburg & CO
Hypothekenbank AG
Colonnaden 5
20354 Hamburg
GERMANY
Telephone + 49 40 355334-0
Telefax + 49 40 355334-19
Internet: www.warburghyp.de

Westfälische Hypothekenbank AG
Florianstrasse 1
44139 Dortmund
GERMANY
Telephone + 49 231 1082-0
Telefax + 49 231 1082-257
Internet: www.westhyp.de

Westfälische Landschaft
Bodenkreditbank AG
Schorlemerstrasse 16
48143 Münster
GERMANY
Telephone + 49 251 4905-0
Telefax + 49 251 4905-111
Internet: www.wl-bank.de

Württembergische Hypothekenbank AG
Büchsenstrasse 26
70174 Stuttgart
GERMANY
Telephone + 49 711 2096-0
Telefax 49 711 2096-304
Internet: www.wuertt-hyp.de

Wüstenrot Hypothekenbank AG
Im Tambour 6
71630 Ludwigsburg
GERMANY
Telephone + 49 7141 16-1
Telefax + 49 7141 16-5600
Internet: www.wuestenrot.de

Guest member:

Deutsche Schiffsbank AG
Domshof 17
28195 Bremen
GERMANY
Telephone + 49 421 3609-0
Telefax + 49 421 323539
Internet: www.schiffsbank.com

Officers of the Association of German Mortgage Banks*

President

DR. KARSTEN VON KÖLLER
Chairman of the Board of Managing Directors
Eurohypo AG,
Frankfurt am Main

Board

DR. KARSTEN VON KÖLLER
(Chairman)
Chairman of the Board of Managing Directors
Eurohypo AG,
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DR. EGBERT EISELE
Member of the Board of
Managing Directors (retired)
Bayerische Hypo- und Vereinsbank AG,
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DR. PAUL EISELE
Member of the Board of Managing Directors
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Member of the Board of Managing Directors
Deutsche Hypothekenbank (Act.-Ges.),
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General Manager and Member of the Board
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Deputy Chairman of the Board of
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Eurohypo AG,
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General Manager and Member of the Board
German Banking Association,
Berlin

DR. WALTER WEBER
Member of the Board of Managing Directors
Deutsche Genossenschafts-
Hypothekenbank AG,
Hamburg

* As at February 28, 2003

Organizational Structure of the Association of German Mortgage Banks

Management

General Manager
and Member of the Board:
Dr. Louis Hagen
Telephone: + 49 30 20915-110
Telefax: + 49 30 20915-119
e-mail: hagen@hypverband.de

Managing Director:
Dr. Otmar Stöcker
Telephone: + 49 30 20915-210
Telefax: + 49 30 20915-119
e-mail: stoecker@hypverband.de

Property Sector

Head:
Achim Reif
Telephone: + 49 30 20915-410
Telefax: + 49 30 20915-519
e-mail: reif@hypverband.de

Specialist officer:
Rebecca Holter
Telephone: + 49 30 20915-430
Telefax: + 49 30 20915-519
e-mail: holter@hypverband.de

Mortgage Bank Act (HBG), International Business, System Marketing

Head:
Dr. Otmar Stöcker
Telephone: + 49 30 20915-210
Telefax: + 49 30 20915-119
e-mail: stoecker@hypverband.de

Specialist officers:
Tim Lassen
Telephone: + 49 30 20915-220
Telefax: + 49 30 20915-119
e-mail: lassen@hypverband.de

Andreas Luckow
Telephone: + 49 30 20915-250
Telefax: + 49 30 20915-119
e-mail: luckow@hypverband.de

Capital Markets

Head:
Dr. Louis Hagen
Telephone: + 49 30 20915-110
Telefax: + 49 30 20915-119
e-mail: hagen@hypverband.de

Specialist officer:
Annette Zimmer
Telephone: + 49 30 20915-320
Telefax: + 49 30 20915-419
e-mail: zimmer@hypverband.de

EU Relations Brussels Office

Head:
Wolfgang Kälberer
Telephone: + 32 2 7324-638
Telefax: + 32 2 7324-802
e-mail: kaelberer@hypverband.de

Specialist officer:
Inga Hager
Telephone: + 32 2 7324-638
Telefax: + 32 2 7324-802
e-mail: hager@hypverband.de

Law, Banking Regulations, Taxes

Head:
Dr. Christian Marburger
Telephone: + 49 30 20915-510
Telefax: + 49 30 20915-319
e-mail: marburger@hypverband.de

Specialist officers:
Andrea Haustein
Telephone: + 49 30 20915-520
Telefax: + 49 30 20915-319
e-mail: haustein@hypverband.de

Rainer Pfau
Telephone: + 49 30 20915-530
Telefax: + 49 30 20915-319
e-mail: pfau@hypverband.de

Communications

Head:
Dr. Helga Bender
Telephone: + 49 30 20915-330
Telefax: + 49 30 20915-119
e-mail: bender@hypverband.de

Specialist officer:
Christian Walburg
Telephone: + 49 30 20915-340
Telefax: + 49 30 20915-419
e-mail: walburg@hypverband.de

Head Office:

Georgenstrasse 21, 10117 Berlin
GERMANY
Telephone: + 49 30 20915-100
Telefax: + 49 30 20915-101
e-mail: vdh@hypverband.de
www.hypverband.de
www.pfandbrief.org

Brussels Office:

Av. Michel Ange 13
1000 Bruxelles, BELGIUM
Telephone: + 32 2 7324-638
Telefax: + 32 2 7324-802
e-mail: vdh@hypverband.be

Liaison Office in Tokyo:

Association of German
Mortgage Banks
c/o International Financial
Consulting K.K. (IFC)
The Prudential Tower, 21st Floor
2-13-10 Nagatacho, Chiyoda-ku
Tokyo, JAPAN
Telephone: + 81 3 5532-8057
Telefax: + 81 3 5532-8367
e-mail: h.takee@pr-liaison.com

Liaison Office in New York:

Association of German
Mortgage Banks
c/o Makovsky & Company
575 Lexington Avenue, 15th Floor
New York, NY 10022, USA
Telephone: + 1 212 508-9677
Telefax: + 1 212 508-9716
e-mail: pfandbrief@makovsky.com

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Association of German Mortgage Banks
Georgenstrasse 21
10117 Berlin
GERMANY
Telephone +49 30 20915-100
Telefax +49 30 20915-101
E-mail: info@pfandbrief.org
Internet: www.pfandbrief.org

Mailing address:
P.O. Box 64 01 36
10047 Berlin
GERMANY

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