

Cover Me: The Economy Is on Fire (The German *Pfandbrief*)

By Patrick Quirk*

“No German mortgage bank has defaulted since the introduction of the German Mortgage Bank Act in 1900.”¹

A. Introduction

This article examines the German *Pfandbrief* (“covered bond”) as an example of the banking practice of “originate to hold” by which mortgage debts are retained on the balance sheet of the originator and not sold on to a third party such as an investor or hedge fund. The global financial crisis (GFC) of 2008-2009² will be forever linked to the process known as “securitization” and the distribution of mortgage-backed securities throughout willing and later remorseful financial markets. But this is not the only model. As a member of the Executive Board of the European Central Bank (ECB) noted in June of 2008, “it may be worth recalling that this [originate to distribute model] is not the way banks have historically done business. Under the traditional—perhaps, I should say secular—‘originate to hold’ business model, banks extend loans to firms and households and hold them in their balance sheets until they mature or are paid off.”³

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¹ Orazio Mastroeni, *Pfandbrief-style products in Europe*, European Central Bank, BIS Papers No.5, 63.

² Other terms have been use in its description, including, credit squeeze, credit bubble, housing crisis, and distressed credit market crisis.

³ José Manuel González-Páramo, *Financial turmoil, securitisation and liquidity*, 3, Global ABS Conference 2008, Cannes, 1 June 2008.

The idea of holding assets in this way has a long history in the form of the German *Pfandbrief* and this article will outline some of its major legal characteristics and recent upgrading by the German *Bundestag* (Parliament) in May 2005.⁴

Part B. will consider European “aversion” to securitization and Part C. will outline the history of the German *Pfandbrief*. Part D. will examine specific provisions of the *Pfandbrief* laws, including licensing, supervision, the cover register, risk management, issuing structures, and insolvency privileges.

Part E. will look briefly towards the possible future of the covered bond in the United States and the UK.

The *Pfandbrief* has received very little consideration in academic legal literature. This article invites more detailed consideration of its origins and characteristics since its regulatory structure has served as an important model for similar systems throughout Europe.⁵ For example, the *Obligations foncières* found in France, Spain’s *Cédulas hipotecarias*, and *Lettres de gage* offered in Luxembourg.

So-called “*Pfandbrief* banks,” with their obligatory license from German authorities and strict quality controls, are known for their stability and permanence. According to the Association of German *Pfandbrief* Banks,⁶ no *Pfandbrief* has failed in more than 100 years.⁷ They are said to be attractive even in unfavorable financial times because they “provide issuers with access to liquidity at all times. . . [and] . . . can therefore finance new business with substantial margins even in a difficult market environment.”⁸

A final caveat before proceeding to matters of substance concerns the dangers inherent in explaining and interpreting foreign legal terms. Direct translation may not produce

⁴ See Gesetz zur Neuordnung des Pfandbriefrechts, 22 May, 2005; amendments beyond this date will not be considered.

⁵ See Norton Rose LLP, *German Pfandbriefe: a modern financing tool in demand*, client publication (December 2008) available at <http://www.nortonrose.com/knowledge/publications/2008/pub18574.aspx?page=all&lang=en-gb>, (last visited Feb. 5, 2009).

⁶ See Verband Deutscher Pfandbriefbanken (‘VDB’), *Representing Germany’s Pfandbrief Banks*, available at http://www.pfandbrief.de/d/internet.nsf/tindex/en_about.htm, (last visited Feb. 5, 2009). This is the lobbying body for the group of approximately 36 banks that are engaged in the *Pfandbrief* market.

⁷ See Verband Deutscher Pfandbriefbanken, *The Pfandbrief – a premium product*, 16, presentation prepared for analysts’ conference call (26 Feb. 2008) available at [http://www.pfandbrief.de/d/internet.nsf/0/346DAA456C29D09AC125741F00254245/\\$FILE/PfandbriefPremiumProduct.pdf](http://www.pfandbrief.de/d/internet.nsf/0/346DAA456C29D09AC125741F00254245/$FILE/PfandbriefPremiumProduct.pdf) (last visited Feb. 5, 2009).

⁸ *Id.* 4.

accurate rendering of the underlying concepts. One may never assume, for example, that one of the (several) German words for mortgage (*Hypothek*)⁹ carries along with it precisely the same meaning as the English word “mortgage.”¹⁰ Nevertheless, “. . . to understand a foreign solution to a familiar problem is often rewarded with a clearer grasp of one's own law”¹¹ and this is the basis on which the following explanation and analysis is offered.

B. The European “Aversion” to Securitization

The United States is the birthplace of modern securitization, beginning with the mortgage-backed security of the 1970s.¹² European banks were much slower to adopt this technique and were arguably better placed to weather the initial stages of the 2008-2009 crisis,¹³ although they too have been directly and indirectly exposed to turmoil.

One may hypothesize that their late entry to the game of securitization means that European bankers find it easier to remember what “old style” banking was all about.¹⁴ Many banks in Europe were active in the securitization market, and (as for the rest of the world) activity for 2008 fell below those of previous years.¹⁵ During the 2008-9 global financial crisis, there were a number of alarming defaults, including that of Northern Rock¹⁶ in the United Kingdom, and problems for some German banks such as IKB Deutsche

⁹ *Hypothek* is one way of presenting the idea of a real property mortgage. The word *Grundschuld* is also sometimes used and may be translated as “Abstract land charge”.

¹⁰ Even if it did, there are many other aspects to land transfer that would not find equivalent meaning. For example, the time periods and other procedures involved in standard land transfer or in registration or discharge of a mortgage.

¹¹ F.H Lawson, *The Field of Comparative Law*, 61 JURID. REV 16 (1949).

¹² See Randall Dodd, *Subprime: Tentacles of a Crisis*, 44 FIN. & DEV. 15 (International Monetary Fund Dec. 2007) (stating that the early roots of a secondary market for housing mortgages arguably lie in Roosevelt's New Deal, and the founding in 1938 of the Federal National Mortgage Association (Fannie Mae)).

¹³ See Oz Shy & Rune Stenbacka, *Rethinking the Roles of Banks: A Call for Narrow Banking*, THE ECONOMISTS' VOICE: Vol. 5: 2 (2008) available at <http://www.bepress.com/ev/vol5/iss2/art6> (stating that notwithstanding the UK's Northern Rock and other bailouts, some have used this disaster as a basis to argue for drastically “narrower” (simplified, less risky, more transparent) banking services for those who want them). The average Northern Rock depositor and the UK government would perhaps both have been glad of this advice.

¹⁴ See *supra* José Manuel González-Páramo, note 2.

¹⁵ See *ESF Securitisation 2008 Market Outlook*, European Securitisation Forum, available at www.europansecuritisation.com.

¹⁶ The Bank of England supplied emergency financial aid to this mortgage lender on 14 September, 2007; it was subsequently nationalized on 22 February 2008. This fiasco included the first bank run in Britain in roughly 140 years.

Industriebank,¹⁷ WestLB, and SachsenLB.¹⁸ Iceland also suffered severe financial, political and social unrest.¹⁹ Ratings agency Standard and Poors issued a press release on 19 September 2007 to reassure its clients about the German banks' exposures to U.S. subprime mortgages²⁰ and the *Verband Deutscher Pfandbriefbanken* (Association of German Covered Bond Banks–VDP) made it clear to investors in early 2008 that its members had low exposure to US residential housing risk.²¹

Despite the advent of the Euro in 1999, the European Central Bank does not directly oversee individual banks. This task is left to local authorities which in the case of Germany is divided between the *Bundesbank*, (Federal Reserve Bank) (overall financial strength), and the *Bundesanstalt für Finanzdienstleistungsaufsicht* (Federal Institute for the Supervision of Financial Services–“BaFin”) which is responsible for levying fines and other administrative and supervisory functions.²²

There are a number of bankruptcy and commercial laws that drive the securitization process in the USA²³ and as commentators have pointed out, these are modified in various European jurisdictions.²⁴

¹⁷ See Peter Gumbel, *Subprime on the Rhine*, FORTUNE, 3 Sept. 2007, available at http://w4.stern.nyu.edu/news/news.cfm?doc_id=7571 (listing IKB Deutsche Industriebank as a Düsseldorf-based commercial bank).

¹⁸ Recently purchased 1 January 2008 by the Stuttgart-based Landesbank Baden-Württemberg.

¹⁹ See Judy Dempsey, *Iceland's Government Collapses*, NEW YORK TIMES, 26 Jan. 2009.

²⁰ See Standard & Poors, *German Banks' Subprime Mortgage And Structured Vehicle Exposure Concerns Are Overstated* (19 Sept. 2007) (“... we consider that credit risk in the German banking sector from U.S. subprime mortgage exposures is limited as it is generally concentrated in the 'AAA' and 'AA' rated tranches and we consider the potential market valuation effects to be manageable.”).

²¹ See Verband Deutscher Pfandbriefbanken (Association of German Pfandbrief Banks), Analysts' Conference Call, 20, 26 Feb. 2008 (noting that there was limited exposure to apartments and multi-family dwellings but no exposure to single-family housing). This is for to say that some German banks did not buy US sub-prime assets and suffer the consequences. IKB Deutsche Industriebank is one example. See *Subprime on the Rhine*, FORTUNE, 9 March 2007.

²² See BaFin web page, www.bafin.de. “BaFin has 1,600 employees working in Bonn and Frankfurt am Main. They supervise around 2,079 banks, 718 financial services institutions, 633 insurance undertakings, 26 pension funds, 6,000 investment funds and 78 investment companies (as of January 2008). BaFin operates only in the public interest. Its primary objective is to guarantee the proper functioning, stability and integrity of the German financial system. Bank customers, insurance policyholders and investors are meant to be able to trust the financial system. Under its solvency supervision remit, BaFin ensures the ability of banks, financial services institutions and insurance undertakings to meet their payment obligations. Through its market supervision, BaFin also enforces standards of professional conduct which preserve investors' trust in the financial markets. BaFin also has an investor protection role in that it seeks to prevent unauthorised financial business being carried out.”

²³ Most notably the ability to render a “true sale” of debts that have been securitized under Article 9 of the Uniform Commercial Code.

German law experts have outlined the complicated legal issues surrounding a securitization in Germany.²⁵ Such explanations typically assume familiarity with the US markets and lie beyond the scope of this paper.

C. The *Pfandbrief*—A History

The *Pfandbrief* has nearly 250 years of history. Frederick the Great, King of Prussia (1712-1786),²⁶ instigated the first issue of the *Pfandbrief* on 29 August 1769, in the wake of the Silesian War and in response to a bankrupt nobility and a ruined Silesia where most “Buildings had been burned, cattle driven away, implements destroyed, and losses of all kinds suffered.”²⁷ Frederick was known as an enlightened despot, correspondent of Voltaire, and builder of the famous rococo palace of Sans Souci at Potsdam.²⁸

In 1767, in the midst of an ensuing credit squeeze, high interest rates, and rising commissions, a merchant named Büring had offered Frederick a written plan for the founding of a credit association that promised marvels. The plan would bring about an “abundance of money and credit for the country and for the safest manner in which to begin assisting the impoverished nobility.”²⁹ Initially rejected, the nobility, or a sizeable portion of the “best families,”³⁰ were saved by the adoption of the plan in 1770 and the launching of *Die schlesische Landschaft* as the first German credit association. Many others followed.³¹

²⁴ Christopher Lewis Peterson, *Over-Indebtedness, Predatory Lending, and the International Political Economy of Residential Home Mortgage Securitization: Comparing the United States' Subprime Home Mortgage Lending Crisis to Home Finance in the United Kingdom, Germany, and Japan*, SSRN Paper (11 Jan. 2008) available at <http://ssrn.com/abstract=1083184>.

²⁵ Michael Kern & Werner Meier (Cleary Gottlieb Steen & Hamilton LLP), *Chapter 20 - German* in THE INTERNATIONAL COMPARATIVE LEGAL GUIDE TO: SECURITISATION 2007, (Global Legal Group, 2007).

²⁶ See JOHN MERRIMAN, A HISTORY OF MODERN EUROPE FROM THE RENAISSANCE TO THE PRESENT, 432-434 (WW Norton & Co. 1996). Frederick II of Prussia, also known as “Frederick the Great”, his rule was known for its “enlightened absolutism,” judicial reforms, an examination system for entry into the state bureaucracy, bolstering the position of Prussian nobles (e.g. he maintained serfdom in the private estates while others were working for its abolition), prohibiting marriage between nobles and commoners, and preventing the sale of noble lands to commoners..

²⁷ D. M. Frederiksen, *Mortgage Banking in Germany*, 9 Q. J. OF ECON. 47, (1894) [hereafter Frederiksen].

²⁸ See Giles MacDonogh, FREDERICK THE GREAT: A LIFE IN DEED AND LETTERS (2001).

²⁹ *Id.* at 47 (translation as published in *Der Deutsche Oekonomist*, 3 June 1894).

³⁰ Frederiksen, *supra* note 27, at 51.

³¹ Kur and Neumark, 1777; Pommern, 1780; Hamburg, 1782; Westpreussen, 1787; Ostpreussen, 1788; Lüneburg, 1791; Schleswig-Holstein, 1811; Mecklenburg, 1818 and 1840; Posen, 1822; Würtemberg, 1825; Calenberg, Grubhagen, and Hildesheim, 1825; Bremen an Verden, 1826. Frederiksen, p. 52.

The plan began with a valuation of an estate, followed by an advance against it of one half to two-thirds of that value in order to pay off “annoying creditors.”³² The creditors were paid with bonds issued by the *Landschaftscasse* (“*Casse*”)³³ and guaranteed by it both as to principal and interest. The bonds³⁴ were payable to bearer and yielded a rate of 4% (annually) while the debtor-noble was required to pay 4½ to 5 percent semi-annually to the *Casse*—and “thus the old debts of the estate shall be settled.”³⁵ The interest differential provided for salaries and overheads of the *Casse*, as well as insurance in case of “accidents such as death of livestock, hail-storms, fire, droughts, and war.”³⁶ Failure by the debtor to pay the mandated interest would lead to sale of the estate.³⁷

There was a prohibition on the bonds leaving the country or on foreigners making purchase of them through local agents.³⁸ The plan was designed to produce a large quantity of currency by which land-owners could relieve themselves of their debt to the *Casse*.

Gradual innovations were made, including the removal of cattle and implements from valuation,³⁹ and the gradual amortization of loans through sinking funds. The subsequent growth of this method of financing has been outlined in detail elsewhere,⁴⁰ but by the end of the nineteenth century it was observed that “while all attempts to base money on land have failed, this proposal, which resulted in the establishment of associations for the issue of long-term listed bonds based on land, is the origin of all modern methods of organized mortgage banking as it is now carried on on the Continent of Europe.”⁴¹

Several key aspects of the various credit associations are noticeable. First, the amounts loaned typically ranged “from one third to one half of the actual value of the property, and

³² Frederiksen, *supra* note 27, at 48.

³³ Also called a *Hypothekencasse*.

³⁴ Which might also be named “provincial mortgage coupons” or in more modern parlance, debentures.

³⁵ Frederiksen, *supra* note 27, at 48.

³⁶ *Id.* at 48.

³⁷ As opposed to any form of receivership “for on that rests an eternal curse.” Frederiksen, *supra* note 27, at 48.

³⁸ *See id.* at 49.

³⁹ Land owners would apparently “borrow” cattle from neighbors of the purposes of valuation. *See id.* at 48.

⁴⁰ *See id.* at 48.

⁴¹ *Id.* at 60.

less than two thirds of the assessed valuation."⁴² Second, they were under government supervision in the sense that excessive valuations were prohibited.⁴³ Third, in certain cases of loans made against the value of buildings, such buildings had to have been in use for three years and have relevant fire insurance.⁴⁴ Valuations were to be related to "average net income for the last three to five years"⁴⁵ and the loan amount was a fixed proportion of the valuation.⁴⁶

On 1 January 1900 the German legislators passed the Mortgage Bank Act (*Hypothekbankgesetz*, HBG) that allowed *Pfandbriefe* to be issued by private mortgage banks. In 1927, the passage of the Public *Pfandbrief* Act extended this to public sector banks.

D. The Modern *Pfandbrief*

The *Pfandbrief* is the German compartment of the European covered bond market and has substantial market share of the global covered bond market. In literal translation, a *Pfandbrief* may be called a *Letter of Pledge*,⁴⁷ although extreme care must be taken in translation of this legal terminology.⁴⁸ In terms more understandable in the twenty-first century United States, a *Pfandbrief* is a plain vanilla bond or debenture⁴⁹ that is backed ("covered") by an on-balance-sheet asset pool and regulated by special German legislation to ensure that value remains equal to or greater than the outstanding obligation. They are considered very secure since "in the event of the issuing mortgage bank becoming insolvent, the creditors would receive a preferential claim over the assets in the cover

⁴² *Id.* at 55.

⁴³ *See id.* at 55.

⁴⁴ *See id.* at 56. The amount of the loan was not to exceed the actual cost of the building.

⁴⁵ *Id.* at 56.

⁴⁶ *Id.* "Usually, the amount that may be loaned by the credit associations is limited, so as to be within a certain proportion of the assessed valuation of the property." *Id.*

⁴⁷ Graham "Harry" Cross, *The German Pfandbrief and European Covered Bonds Market* in THE HANDBOOK OF EUROPEAN FIXED INCOME SECURITIES, [hereinafter Cross] 201, note 1 (Frank J. Fabozzi & Moorad Choudhry eds., 2004).

⁴⁸ In Anglo-American systems a pledge is a very old form of security. As far back as 1703, Chief Justice Holt noted that the "fourth sort [of bailment] is, when goods or chattels are delivered to another as a pawn to be a security to him for money borrowed of him by the bailer; and this is call in Latin *vadium*, and in English a pawn or a pledge." *Coggs v. Barnard*, 92 Eng. Rep. 999 (2 Ld. Raym, 909) (1703).

⁴⁹ They are also sometimes translated as "bank debentures". The distinction between "bond" and "debenture" is not strictly upheld in modern finance.

pool, which is there solely to protect them.”⁵⁰ They also might be said to enjoy an informal backing by the German federal government due to their close supervision.⁵¹

I. Licensing, Supervision and General Provisions

Chapters 1, 2 and 7 of the *Pfandbrief* Act deal with important licensing and supervision questions. They also provide general provisions dealing with, *inter alia*, fiduciary duties.

Those banks issuing *Pfandbriefe* may only do so under special license from the German government. In summary, the requirements for this license are:

- (1) Core capital (*Kerncapital*) of at least 25 million euros.
- (2) A general banking license permitting lending within the meaning of the German Banking Act (*Kreditwesengesetz*).
- (3) Appropriate risk management procedures and instruments.
- (4) A business plan showing regular and sustainable issue of *Pfandbriefe*, as well as necessary organizational structure.⁵²

Once issued, a licence may be revoked by the *Bundesanstalt* (Federal Authority) if these requirements are no longer met, or if the *Pfandbrief* bank has not issued *Pfandbriefe* for more than two years and does not expect to regularly resume doing so within the next 6 months.⁵³ In the event that a licence is revoked or expires, all cover pools must be settled⁵⁴ by an appointed cover pool administrator in accordance with §30-36 (see below).

Supervision of *Pfandbrief* banks is carried out by the *Bundesanstalt*.⁵⁵ This body may give “all orders as are appropriate and necessary” to ensure compliance with the *Pfandbrief*

⁵⁰ Cross, *supra* note 47, at 201-202.

⁵¹ See *id.* at 202.

⁵² Questions on German Covered Bond Legislation, Dr Otmar Stöcker, Managing Director, Association of German Pfandbrief Banks, 13.9.06 on file with author; See also §2(1) of Pfandbrief Act.

⁵³ See Pfandbrief Act, §2(2).

⁵⁴ See *id.* §2(3).

⁵⁵ See *id.* §3.

Act, and must conduct random checks (generally every two years) of the “cover” provided.⁵⁶

General provisions are set out in §4-11. With respect of mortgage asset value, §4 provides the critical “matching cover” requirement:

The respective total amount of *Pfandbriefe* outstanding of any one class must at all times be covered at their nominal value by assets at least in the same amount and with at least the same interest income. If the redemption value known at the time of the *Pfandbrief* issue exceeds the nominal value, the nominal value shall be replaced by such redemption value.⁵⁷

This “matching cover” principle, as it is known means in simple terms that the nominal value of the bonds must always “match” the value of those assets that are offered as collateral. In addition, §4(2) requires that cover always be the same as or greater than the net present value⁵⁸ of the cover plus 2% (“security excess cover”). This security excess cover must be in especially liquid assets such as bonds, Treasury bills, or balances with the European Central Bank.⁵⁹

Section 4(3) deals with *Pfandbrief* bank liabilities that are made up of derivatives used as cover and provides that, “To the extent that any liabilities of the *Pfandbrief* bank are constituted under derivatives used as cover, the claims of the counterparties of the *Pfandbrief* bank must also be covered.”

Pfandbrief banks are under a duty to document their cover in a transparent manner at all times.⁶⁰ Paragraph 4(5) provides that *Pfandbriefe* are deemed outstanding (*Im Umlauf*) if they are “executed pursuant to § 8 para. 3 and handed over to the *Pfandbrief* bank by the

⁵⁶ *Id.* §3

⁵⁷ *Id.* §4(1).

⁵⁸ Net Present Value is the “discounted value of an investment's cash inflows minus the discounted value of its cash outflows. To be adequately profitable, an investment should have a net present value greater than zero. Net present value is a tool for evaluating an investment proposal.” THE AMERICAN HERITAGE DICTIONARY OF BUSINESS TERMS, Houghton Mifflin Harcourt (2009). According to §4(6) of the Covered Bond legislation, the Federal Ministry of Finance (*Bundesministerium der Finanzen*) together with the Federal Ministry of Justice (*Bundesministerium der Justiz*) may promulgate rules for calculating the net present value.

⁵⁹ See *Pfandbrief Act*, §4 (2) 1, 2, & 3 (providing a full list).

⁶⁰ See *id.* §4(4).

fiduciary agent; if a *Pfandbrief* is returned to the fiduciary agent for safekeeping, it shall for the period of such safekeeping not be deemed outstanding.”⁶¹

Pfandbrief banks are not permitted to issue covered bonds that are not covered by assets in the register (see below). Further, banks are prohibited from disposing of assets in the register “to the detriment of *Pfandbrief* creditors.”⁶² *Pfandbriefe* may not be put into circulation without certification under §8(3).⁶³

Chapter 7 of the *Pfandbrief* Act contains 13 provisions (§41-53) that deal *inter alia* with transitional matters concerning licensing, insurance, lending limits, and certain preferential rights of ship *Pfandbrief* creditors.

Section 41 governs the use of the three principal designations (Mortgage *Pfandbrief*, Public *Pfandbrief* and Ship *Pfandbrief*) provided for in §1.⁶⁴ These designations can only be used by those credit institutions licensed to conduct *Pfandbrief* business, or by those deposit-taking institutions (*Einlagenkreditinstitute*) with their “seat” in another EEA⁶⁵ or EU Member State (apart from Germany) and satisfying certain conditions, including various EU Directives.⁶⁶

II. Cover Register

The cover register is provided for in §5. Each *Pfandbrief* class must have its own ‘cover register’ that is maintained by the issuing *Pfandbrief* bank. Derivatives cannot be recorded without special permission of the fiduciary agent and the counterparty of the *Pfandbrief* bank.⁶⁷ The final sentence of §5(1) provides that, “If an asset required for cover is repaid, the party responsible for the recording of the cover assets shall record corresponding substitute assets in the cover register without delay.”

⁶¹ *Id.* §4(5).

⁶² *Id.* §4(7). This provision goes on to prohibit sale to the detriment of “the creditors of claims under derivatives pursuant to para. 3 despite the remaining assets recorded in the respective register not being sufficient to cover as prescribed the respective *Pfandbriefe* and the claims under derivatives pursuant to para. 3.”

⁶³ *See id.*, §4(7).

⁶⁴ *See id.* §1(1) sentence 2, numbers 1-3.

⁶⁵ European Economic Area. Members are signatories of the Agreement on the European Economic Area (EEA) (1991) also known as the “Porto Treaty”. The Treaty permits countries to be part of certain economic aspects of the EU (the “four freedoms”) without being obliged under political aspects.

⁶⁶ *See Pfandbrief Act*, §41(2).

⁶⁷ *Id.* §5(1).

The easy identification of cover assets has a number of important effects. First it allows for rapid and easy identification of assets in the event of a bankruptcy. Second, this identification in turn allows for segregation of the assets to take place and prevents them being drawn into the bankrupt estate. Third, the register makes it relatively easy for regulators to see what kind and quality of cover exists for the outstanding bonds on the register. Finally, the register allows the independent fiduciary agent to monitor the cover assets. The fiduciary agent must notify BaFin of entries each six months. The precise form of entries on the cover register itself are governed by statutory order pursuant to §5(3).

Section 6 mandates that *Pfandbriefe* shall set out legal terms of the relationship between the *Pfandbrief* bank and the *Pfandbrief* creditors.⁶⁸ The latter are not allowed a “cancellation right” (*Kündigungsrecht*) and there is also prohibition on the issue of *Pfandbriefe* where the redemption value is unknown.⁶⁹

Section 7 provides for fiduciary agents (*Treuhänder*) and their deputies (*Stellvertreter*)—at least one of each must be appointed for each *Pfandbrief* bank.⁷⁰ Conflicts of interest are prohibited⁷¹ and agents and their deputies must have requisite knowledge. This will be presumed in the case of auditors (*Wirtschaftsprüfer*) or chartered accountants (*vereidigter Buchprüfer*).⁷² Fiduciary serve at the pleasure of the Federal Authority (*Bundesanstalt*) which both makes the appointment and may revoke it at any time for objective reasons (*sachlichem Grund*).⁷³ While the fiduciary agent must report to the Federal Authority, he or she is not bound by their instructions.⁷⁴ General duties of the fiduciary agent are set out in §8, while special duties of safekeeping are regulated under §9 and powers under §10. Section 11 regulates remuneration and dispute resolution. Each of these deserves some limited further explanation.

General duties (§8) of the fiduciary agent include ensuring that prescribed cover (*vorschriftsmässige Deckung*) as well as derivative claims (§4(3)) are always in place. This means that the value of mortgaged properties under §16(4), and the value of ships (or ships in process of construction) under §24(5) must be correctly determined. However, the

⁶⁸ See *id.* §6(1).

⁶⁹ *Id.* §6(2) and §6(3).

⁷⁰ *Id.* §7(1).

⁷¹ *Id.* §7(2) (prohibiting partiality). Those with employment or client relationships with the bank during the previous three years are excluded on this ground.

⁷² See *id.* §7(2).

⁷³ See *id.* §7(3).

⁷⁴ See *id.* §7(4).

fiduciary is not obliged to go beyond these provisions in determining whether actual and determined values correspond.⁷⁵ Under §8(2) the fiduciary must ensure recording of assets in the cover register. *Pfandbrief* bank counterparties are entitled to notification by the fiduciary if any derivative is recorded in the cover register. Before any *Pfandbrief* is issued, the fiduciary must certify that prescribed cover is available and recorded in the register.⁷⁶ Once entered, assets listed in the register can only be cancelled by the fiduciary agent, in writing. Cancellation of any (unsatisfied) registered derivative shall also require consent of the relevant counterparty.⁷⁷ Failure to gain consent will deem the cancellation ineffective.⁷⁸

The duties of “safekeeping” provision (§9) sets up a system of control (safe custody) of cover assets. The fiduciary (or his designee) may hold the assets, or, in the case of deeds under dual control (*Mitverschluss*) they may be held jointly. Surrender can only occur under the provisions of the Act and only when the register holds sufficient assets to cover outstanding value of the *Pfandbriefe*.⁷⁹ Temporary surrender is allowed and in this case there is no need to ensure substitute cover.⁸⁰

Under §10, powers of the fiduciary agent extend to broad access to the relevant records held by the *Pfandbrief* bank that relate to the *Pfandbriefe* and their underlying assets.⁸¹ All repayments of principal must be notified by the *Pfandbrief* bank to the fiduciary agent on a continuing basis (*fortlaufende Mitteilung*), along with any other changes to the assets that are of material relevance to the creditors.⁸²

The remuneration and dispute resolution provisions (§11) allow for reasonable fees to be paid by the Federal Authority and then reimbursed by the *Pfandbrief* bank.⁸³ Any disputes between the *Pfandbrief* bank and the fiduciary agent are to be resolved by the Federal Authority.⁸⁴

⁷⁵ See *id.* §8(1), last sentence.

⁷⁶ See *id.* §8(3).

⁷⁷ See *id.* §8(4).

⁷⁸ See *id.*

⁷⁹ See *id.* §9(1) and (2).

⁸⁰ See *id.* §9(3).

⁸¹ See *id.* §10(1).

⁸² See *id.* §10(2).

⁸³ See *id.* §11(1).

⁸⁴ See *id.* §11(2).

III. General Provisions and Risk Management

Chapter 4 of the *Pfandbrief* Law sets out important risk management and transparency provisions. Risk management (§27) mandates risk management systems in the *Pfandbrief* bank's *Pfandbrief* business. In general terms, this extends to the following four risk elements: identification, evaluation, control, and monitoring. In specific terms, the bank is to take into account all counterparty, interest rate, currency, operational, liquidity and "market price" risks.⁸⁵ On top of these, the following applies:

- (1) Risk concentration must be restricted by way of a limit system.
- (2) A procedure must be in place ensuring risk reduction in case of a material increase in risk; the procedure must provide for early notification of the decision-makers.
- (3) The risk management system must be adjusted to changing conditions on a short term basis and be reviewed at least once a year.
- (4) A risk report prepared in accordance with this provision [§27(1)] must be submitted to the management board at appropriate time intervals, at least quarterly.
- (5) The risk management system shall be documented in a detailed and transparent manner.⁸⁶

New products, markets and businesses also require a thorough risk assessment.⁸⁷

Transparency provisions (§28) are extremely detailed.⁸⁸ While not exhaustive, the following list is indicative of the kinds of information that must be publicly disclosed on a quarterly basis: total amounts outstanding on all types of *Pfandbriefe*, corresponding cover pools at differing values, maturities of outstanding *Pfandbriefe*, claims used as cover according to various methods (geographical, amount, residential property, commercial property, one-family houses, retail buildings etc), claims at least 90 days in arrears (again, allocated geographically), numbers of compulsory sales, foreclosures, arrears in interest

⁸⁵ See *id.* §27(1).

⁸⁶ *Id.* §27(1) (Allen and Overy translation, 60).

⁸⁷ See *Pfandbrief Act* §27(2).

⁸⁸ Compared to those required for certain products in other countries, especially the USA. See generally Bobby R. Bean, *Enhancing Transparency in the Structured Finance Market*, 5 SUPERVISORY INSIGHTS 4 (2008).

payments.⁸⁹ Special transparency requirements apply to public and ship *Pfandbriefe*.⁹⁰ From 1 January 2007 all disclosure must include the corresponding amount for the prior year.⁹¹

IV. Offences

Section 37–40 set out criminal and administrative offences designed to safeguard the *Pfandbrief* system.⁹² Imprisonment or a fine under §38 is possible against those who put “uncovered” *Pfandbriefe* into circulation.⁹³ The same penalties apply to breach of §38(2)(disposal) and §38(3)(recording). Administrative penalties (fines up to 100,000 Euros) apply under §39 for putting *Pfandbriefe* into circulation without the requisite certificate of the fiduciary agent.⁹⁴

V. Issuing Structures

There are three basic classes of *Pfandbrief*: Mortgage *Pfandbrief*,⁹⁵ Public *Pfandbrief*⁹⁶ and Ship *Pfandbrief*.⁹⁷ These are defined in the new Act as follows:

(1) **Mortgage *Pfandbriefe***: the issue of covered bonds on the basis of acquired mortgages designated as *Pfandbriefe* or mortgage *Pfandbriefe* (*Hypothekendarlehen*)(hereinafter, Mortgage *Pfandbriefe*);

(2) **Public *Pfandbriefe***: the issue of covered bonds on the basis of acquired claims against public sector

⁸⁹ See *Pfandbrief Act* §27(1)(2).

⁹⁰ See *id.* §28(3) & §28(4).

⁹¹ See *id.* §28(5).

⁹² Chapter 6, *Pfandbrief Act*, Legal Remedies and Offences.

⁹³ See *id.* §38(1). The central cover provision is §4(7) sentence 1.

⁹⁴ See *id.* §39 (1) & §39(2).

⁹⁵ *Hypothekendarlehen*.

⁹⁶ See Annex A1 to Boos, Görke, & Hoegen, *infra* note, at 120 (Defining the Public *Pfandbrief* to include “the issue of covered bonds on the basis of acquired claims against public sector bodies designated as public sector bonds (*Kommunalschuldverschreibungen*), public sector debentures (*Kommunalobligationen*) or public *Pfandbriefe* (*Öffentliche Pfandbriefe*)).

⁹⁷ The Act does not cover Aircraft *Pfandbriefe*.

bodies designated as public sector bonds (*Kommunalschuldverschreibungen*), public sector debentures (*Kommunalobligationen*) or public Pfandbriefe (*Öffentliche Pfandbriefe*) (hereinafter, Public Pfandbriefe);

(3) **Ship Pfandbriefe**: the issue of covered bonds on the basis of acquired ship mortgages designated as ship Pfandbriefe (*Schiffspfandbriefe*) (hereafter Ship Pfandbriefe).⁹⁸

The assets allowed to support various types of *Pfandbrief* are carefully defined.

1. Mortgage Pfandbrief (*Hypothekenspfandbrief*)

Mortgage *Pfandbriefe* (*Hypothekenspfandbriefe*) are governed by the particular provisions contained in §12 – §19 of the German Act on the Reorganization of *Pfandbrief* Legislation (Chapter 3, sub-chapter 1).⁹⁹ These rules provide for both the type and location of the security. In terms of type, the mortgage must encumber real property or, if they are from a foreign jurisdiction, something similar (§13(1)). They must be located either in a member state of the European Union (EU) or the European Economic Area (EEA), Switzerland, the USA, Canada or Japan (§13(1)). In addition, should a bank choose to lend in states that are not EU members, a maximum 10% cap will apply unless preferential rights are secured under §30(1) (*see* insolvency privileges below). Mortgage lending against time-limited rights is only allowed if planned redemption of the mortgage occurs at least ten years before expiry of the time-limited right.¹⁰⁰

Under §14(1), the law provides for a 60% upper value limit on the amount that a mortgage may cover in relation to the real property value. Value is estimated under §16 (*see* below) and this “mortgage lending limit” is reinforced by a deeming provision that ensures mortgages are only deemed registered up to the 60% limit. Mandatory insurance of buildings erected on the mortgaged real property is required under §15. In the case that the mortgage does not provide recourse against any possible insurance claim, the *Pfandbrief* bank must get additional security by contract.

⁹⁸ Annex A1 to Boos, Görke, & Hoegen, *infra* note 120, at 48.

⁹⁹ *Gesetz zur Neuordnung des Pfandbriefrechts* Vom 22 Mai 2005, *Bundesgesetzblatt Jahrgang 2005 Teil I*, Nr. 29 (promulgated at Bonn on 27 May 2005).

¹⁰⁰ The right must also not exceed “the time period required for the book depreciation of the building in line with economic principles” (*Bundesverband Öffentlicher Banken Deutschlands* translation. P. 54.)

Assessment of lending value under §16 contains a number of important conditions. First, the valuer must have necessary expertise and not be involved in the loan decision (§16(1)). Second, the lending value must not go beyond a “prudent assessment” of “future marketability” of the real estate. Such assessment will take note of “long term sustainable features” of the real estate, “normal local market conditions”, and “present and potential alternative types of use.”¹⁰¹ Thirdly, “speculative elements shall not be taken into account.”¹⁰² Fourthly, the “lending value may not exceed a market value calculated in a transparent manner and in accordance with a recognized valuation method.”¹⁰³ Importantly, after setting these parameters for *lending* value, the law defines *market* value as follows:

The market value is the estimated amount for which a mortgaged property on the date of valuation could be sold between a willing seller and a willing buyer in an arm's length transaction after proper marketing, in which transaction each party is acting knowledgeably, prudently and without compulsion.¹⁰⁴

This definition is somewhat similar to that found in US¹⁰⁵ and UK¹⁰⁶ case law.

There are also special provisions for mortgages on building sites (*Bauplätze*) and new buildings (*Neubauten*)(§16(3)). Pits, quarries and mines are excluded from the law and may not be used as collateral for covered bonds and likewise properties that do not yield permanent income.

¹⁰¹ Pfandbrief Act 16(2).

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*(Bundesverband Öffentlicher Banken Deutschlands translation, 54).

¹⁰⁵ See *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994) (providing the issues inherent in calculating the market value based on the price at a forced sale). According to the US Supreme Court “The market value of a piece of property is the price which it might be expected to bring if offered for sale in a fair market; not the price which might be obtained on a sale at public auction or a sale forced by the necessities of the owner, but such a price as would be fixed by negotiation and mutual agreement, after ample time to find a purchaser, as between a vendor who is willing, but not compelled, to sell and a purchaser who desires to buy but is not compelled to take the particular piece of property. In short, “fair market value” presumes market conditions that, by definition, simply do not obtain in the context of a forced sale.” *Id.*

¹⁰⁶ See *R. v Islam*, [2009] UKHL 30 [2009] (According to the House of Lords “A market, after all, is a place where goods are bought and sold. The market value of goods is the price that they will fetch in that market. It is the price which a willing seller will accept for them from a willing buyer.”), available at <http://www.bailii.org/uk/cases/UKHL/2009/30.html>.

The German Federal Ministry of Finance, together with the Ministry of Justice, may set out rules for and the method and form of assessing mortgage lending value, and may also authorize an easing of valuation requirements for “properties that are predominantly used for residential purposes” (§16(4)).

Commencement of Redemption (*Tilgungsbeginn*) is regulated under §17. Amortization of the share of the mortgage used as cover may be deferred for no more than 10 years. After that time, the amount used as cover must be reduced “by at least the share of the redemption that would be attributable to the share used as cover in case of separate loan agreements and corresponding individual mortgages.”¹⁰⁷ Paragraph 17(2) allows the Federal Authority some discretion to extend beyond 10 years in certain cases.¹⁰⁸ Paragraph 18 renders land charges and foreign security interests equal to mortgages for the purposes of the law. Paragraph 19 provides for additional cover assets.

2. *Public Pfandbrief (Öffentliche Pfandbriefe)*

Cover assets for Public *Pfandbriefe* are regulated under §20. The list of public sector institutions includes (a) domestic political entities that are subject to an unlimited maintenance obligation (*Anstaltslast*), or a guarantee obligation (*Gewährträgerhaftung*); (b) other member states of the EU, EAA, USA, Switzerland, Canada or Japan, and (c) any of their regional government (with conditions); (d) other European States that are members of the OECD; (e) non-profit administrative institutions of the State listed in (b);¹⁰⁹ (f) banks listed in §4 para. 2 sentence 2 no. 1 of the *Pfandbrief* Law. The governments listed in (b) may also give full guarantees.

3. *Ship Pfandbrief (Schiffpfandbriefe)*

Ship *Pfandbriefe* are regulated under §§21–26 of the *Pfandbrief* Law. Lending is limited to ships (and those under construction) that are on a public register (§22(1)), including foreign registers if certain conditions are met.¹¹⁰ Lending must be made via installment

¹⁰⁷ Annex A1 to Boos, Görke, Hoegen, *infra* note 120, at PfandBG §17(1).

¹⁰⁸ See Annex A1 to Boos, Görke, Hoegen, *infra* note 120, at 55, (stating that under §17(2) this will be permitted if “this appears justified due to other liabilities of the debtor related to the granting of the loan, taking into account the condition and the permanent features of the mortgaged property.”).

¹⁰⁹ Again, with compliance with certain EU Directives.

¹¹⁰ These conditions are: “1. a right *in rem* (*dingliches Recht*) can be created in respect of ships and ships under construction, which is recorded in a public register; 2. the right *in rem* grants the creditor security which is similar to a ship mortgage under German law and, in particular, the right to seek satisfaction under the secured loan claim from the ship or the ship under construction; 3. it is not significantly more difficult to bring an action for creditors of other nationalities as compared to their fellow nationals.” Boos, Görke, Hoegen, *infra* note 120, at 58.

loans¹¹¹ of note more than 15 years duration,¹¹² and must not exceed more than 60% of the ship's value as determined by the process under §24. This paragraph contains a number of interesting provisions. First, similar to the requirements of §16, the valuer must not have been involved in the transaction.¹¹³ Second, the valuation must result from a "conservative valuation of the future marketability of the ship" by taking into account the ship's "long term sustainable features," market conditions, as well as current and potential types of use.¹¹⁴ Third, "speculative elements" are to be ruled out.¹¹⁵ Fourth, valuation must be carried out in a "transparent manner" and under a "recognized valuation method."¹¹⁶

The mortgages used to support Mortgage *Pfandbriefe* "must encumber real property, rights equivalent to real property or such rights under a foreign jurisdiction that are similar to rights equivalent to real property under German law."¹¹⁷ Those assets which may support Public *Pfandbriefe* include, broadly-speaking, German "domestic political subdivisions," other states of the European Union (EU) or the European Economic Area (EEA), Switzerland, the USA, Canada or Japan, and certain banks.¹¹⁸

VI. Insolvency Privileges

"Bankruptcy remoteness" is a key attraction of the entire *Pfandbrief* supervisory regime. *Pfandbrief* holders are said to enjoy an insolvency privilege by which the "assets recorded in the cover registers do not form part of the insolvency's estate [sic]."¹¹⁹ Relevant provisions are found in §29–§36 of the *Pfandbrief Act*. §30 provides:

(1) If insolvency proceedings (*Insolvenzverfahren*) have been commenced against the assets of the *Pfandbrief* bank, the assets recorded in the cover registers shall not be part of the insolvency estate (*Insolvenzmasse*).

¹¹¹ See *Pfandbrief Act* §22(2).

¹¹² See *id.* §22(4).

¹¹³ See *id.* §24(1).

¹¹⁴ *Id.* §24(2).

¹¹⁵ See *id.* §24(2).

¹¹⁶ *Id.* §24(2).

¹¹⁷ Annex A1 to Boos, Görke & Hoegen, *infra* note 120, at 53.

¹¹⁸ *Pfandbrief Act* §20; see Annex A1 to Boos, Görke & Hoegen, *infra* note 120, at 56. Other entities also capable of supporting Public *Pfandbriefe* include full members of the OECD, certain banks.

¹¹⁹ Annex A1 to Boos, Görke & Hoegen, *infra* note 120, at 56

The claims of the *Pfandbrief* creditors shall be satisfied in full using the assets recorded in the respective cover register; they shall not be affected by the commencement of insolvency proceedings against the assets of the *Pfandbrief* bank. *Pfandbrief* creditors will participate in the insolvency proceedings only in the scope of para. 6 sentence 4.¹²⁰

Many other insolvency privileges also accrue. First, *Pfandbriefe* do not automatically accelerate when the issuer becomes insolvent.¹²¹ This prevents them becoming due immediately and allows payment in the normal course. Second, judicial intervention in the insolvency estate (e.g. in the form of a stay) will not affect the cover pool, or “special legal estate” of the *Pfandbrief*.¹²² Third, *Pfandbrief* bank insolvency will result in the appointment of “cover pool administrators” who oversee the cover pool of *Pfandbrief* assets for the benefit of the *Pfandbrief* holders. These administrators then receive the right to “administer and dispose of the registered assets.”¹²³ Fourth, if cover assets are not sufficient to satisfy the claims of *Pfandbrief* holders, they may have recourse against other assets of the bank. Fifth, the sale of cover assets to other issuers are facilitated by specific provisions in the *Pfandbrief* Act.¹²⁴

Cover pool administrators are appointed under §30(2) and thereby receive the authority to “administer and dispose” of the registered assets. This halts the right of the *Pfandbrief* bank to dispose of the assets and renders any such disposal ineffective.¹²⁵ Even if assets do not qualify as “cover assets” for the purposes of §14(2), the mortgages will still be subject to the administration and disposal powers of the cover pool administrators.¹²⁶ This does not translate into a windfall for the *Pfandbrief* holders since sentence 3 provides that “the cover pool administrator shall, after deducting reasonable administrative costs, release such share to the insolvency estate as would be attributable to the insolvency estate had

¹²⁰ Karl-Heinz Boos, Oliver Görke & Peter Hoegen, *Das neue Pfandbriefgesetz-Stärkung des Finanzplatzes Deutschland* [The New German *Pfandbrief* Act: Strengthening Germany as a Financial Centre], Allen & Overy, at 62 (May 2005).

¹²¹ See Questions on German Covered Bond Legislation Dr Otmar Stöcker, Managing Director, Association of German *Pfandbrief* Banks, 13 Sept. 2006.

¹²² *Id.*

¹²³ *Pfandbrief* Act §30 (2), sentence 2. If the *Pfandbrief* bank has disposed of an asset recorded in the cover register after the appointment of the cover pool administrator, such disposal shall be invalid (sentence 3).

¹²⁴ See *id.* §32 (1).

¹²⁵ See *id.* §30(2).

¹²⁶ *Id.* §30(3).

there been separate loan agreements and corresponding individual mortgages.”¹²⁷ It is open to the insolvency administrator to demand that the cover pool administrator release cover assets to the insolvency estate provided they are “obviously” not required to meet obligations to the *Pfandbrief* holders.¹²⁸ All assets remaining after *Pfandbrief* holders are satisfied (and administrative costs are met) will be returned to the insolvent estate.¹²⁹ Cover pool administrators may be appointed by the relevant court even before the insolvency commences, provided certain conditions are met.¹³⁰ Creditors with claims under §4(3) are to be treated equally with *Pfandbrief* creditors.¹³¹

The cover pool administrator assumes the *Pfandbrief* bank’s responsibilities under the Act,¹³² subject to the supervision of the relevant court.¹³³ The court may require production of information or reports at any time, and may also dismiss the administrator for cause.¹³⁴ Appointment is made by certificate of the court, publicized in the *Bundesanzeiger* (Federal Bulletin) and *ex officio* (unpublished) in the *Handelsregister* (Commercial register).¹³⁵ The appointment is also registered in the relevant land register (*Grundbuch*) if there is concern that *Pfandbrief* creditors may be at a disadvantage because of non-registration there.¹³⁶ Similar provisions apply to the register of ships and ships under construction.¹³⁷ The cover pool administrator has rights to cover pool assets for remuneration of services rendered and for reimbursement of incurred costs.¹³⁸

¹²⁷ *Id.* §30(3).

¹²⁸ *Id.* §30(4).

¹²⁹ *See id.* §30(4), sentence 2.

¹³⁰ *See* Principally §46a of the Banking Act (*Kreditwesengesetzes*); *Pfandbrief* Act §30(5), sentence 1.

¹³¹ *See* *Pfandbrief* Act §30(8).

¹³² *See id.* §31(1), sentence 4.

¹³³ *See id.* §31(1), sentence 1 (giving authority to the court “having jurisdiction at the seat of the *Pfandbrief* bank.”). The “seat” refers to the place of management under German *Sitztheorie* (“seat theory”). This may be compared to the place of incorporation theory (*Gründungstheorie*) more commonly found in common law systems.

¹³⁴ *See id.* §31(1) sentence 3 This must occur at the request of the Federal Authority;.

¹³⁵ *See id.* §31(2), sentence 3. In cases under §33(5) the *Genossenregister* (register of co-operatives) is appropriate.

¹³⁶ *See* *Pfandbrief* Act §31(3) sentence 1. This will depend on the circumstances the nature of the right.

¹³⁷ *See id.* §31(3) sentence 4.

¹³⁸ *See id.* §31(4).

At the commencement of duty, the cover pool administrator must produce an opening balance sheet and explanatory report.¹³⁹ The cover pool administrator must undertake their duties with due care and diligence.¹⁴⁰ Failure to do so can lead to damages owed to the *Pfandbrief* bank.¹⁴¹

Section 32 allows for the transfer of assets in the cover register to a different *Pfandbrief* bank.¹⁴² Any such transfer must be notarized¹⁴³ and recorded in the commercial register in accordance with §33.

Something less than full transfer is contemplated under §35. This provision permits administration “in a fiduciary capacity by the cover pool administrator of the insolvent *Pfandbrief* bank on behalf of the other (“transferee”) *Pfandbrief* bank, provided that the other *Pfandbrief* bank assumes liability for the covered liabilities of the insolvent *Pfandbrief* bank.”¹⁴⁴ Assets administered in this way shall be treated as if they were assets of the solvent *Pfandbrief* bank even if not formally transferred¹⁴⁵ and shall be so recorded in the relevant assets register.¹⁴⁶ Partial transfer if possible under §36.

VII. *Special Changes in the 2005 Act*

The German *Pfandbrief* system underwent a major overhaul in 2005 with the passing of new federal laws governing this financial product and the financial institutions that provide it.¹⁴⁷ The new Act consolidates a number of older laws,¹⁴⁸ and provides a comprehensive licensing scheme for financial institutions wishing to participate in the market. As stated

¹³⁹ See *id.* §31(5). Annual financial statements and an annual administration report are also required. The financial statement must be audited (§31(5) sentence 2).

¹⁴⁰ See *id.* §31(6) sentence 1.

¹⁴¹ See *id.* §31(6).

¹⁴² See *id.* §31(1).

¹⁴³ *Id.* §31(4).

¹⁴⁴ *Pfandbrief Act* §35(1) sentence 1 (Allen & Overy translation, 66) .

¹⁴⁵ See *Pfandbrief Act* §35(2).

¹⁴⁶ See *id.* §35(3).

¹⁴⁷ *Gesetz zur Neuordnung des Pfandbriefrechts “PfandBG”* [*Pfandbrief Act*], *Bundesgesetzblatt* [Federal Law Gazette], Part I, 1373, 27 May 2005.

¹⁴⁸ Specifically, the Act on Pfandbriefe and Related Bonds of Public Sector Credit Institutions (*Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlicher-rechtlicher Kreditanstalten*; ÖPG); the Mortgage Bank Act (*Hypothekenbankgesetz*; HBG); the Act on Ship Pfandbrief Banks (*Gesetz über Schiffspfandbriefbanken*; SchBKG).

above, qualified financial institutions must possess a core capital of 25 million euros,¹⁴⁹ must supervise risks in accord with the Act,¹⁵⁰ and must have “a business plan demonstrating that it will engage in the *Pfandbrief* business regularly and on a sustained basis and that the required organizational structure is in place.”¹⁵¹ Comparative tables of old regulations and the New German Covered Bond Law (July 2005) are readily available.¹⁵²

VIII. *Pfandbriefe* and the “True Sale” Doctrine

German *Pfandbriefe* do not result in a ‘true sale’ of the relevant mortgages to the Special Purpose Entity (SPE), upon which the magic of securitization depended.¹⁵³ In fact, there is no ‘sale’ at all. They must remain on the balance sheet of the originating bank and cannot be ‘securitized’. Paradoxically, this makes them more ‘bankruptcy proximate’ than the more complicated ‘bankruptcy remote’ SPE. At the same time, as outlined above, the special provisions of the *Pfandbrief* Act render them specially immune from the bankruptcy of the originating bank and secured from the claws of its general creditors.

E. The Future of the Covered Bond in the US and UK

From early 2008, press reports began to sing the praises of the European covered bond as an alternative to the deteriorating securitization market.¹⁵⁴ Emphasis was placed on their “on-balance-sheet” nature and ability to minimize maturity mismatching.¹⁵⁵ Their success in Europe was viewed as a plus,¹⁵⁶ and the Bush Administration was seen to be “pushing”

¹⁴⁹ See *Pfandbrief Act* §2 (§2 *PfandBG*).

¹⁵⁰ See *Pfandbrief Act* §27 (providing for Risk Management).

¹⁵¹ Karl-Heinz Boos, Oliver Görke & Peter Hoegen, *Das neue Pfandbriefgesetz-Stärkung des Finanzplatzes Deutschland* [The New German *Pfandbrief* Act: Strengthening Germany as a Financial Centre], 10 *Allen & Overy* (May 2005).

¹⁵² See Renzo G. Avesani, Antonio García Pascual & Elina Ribakova, *Appendix II: Regulatory Framework for Pfandbriefe and Cédulas Hipotecarias Mortgage Pfandbriefe: A New Regulatory Framework in The Use of Mortgage Covered Bonds*, 20, *IMF Working Paper*, WP/07/20, (2007). This Working Paper does not represent the views of the IMF.

¹⁵³ See Kettering, Kenneth C., *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 *CARDOZO L. REV.* 1553; NYLS Legal Studies Research Paper No. 07/08-7 (2008) (explaining the criticism by leading authors criticizing of this magic), available at SSRN: <http://ssrn.com/abstract=1012937>

¹⁵⁴ Greg Ip, *FDIC Might Set a Policy View on New Mortgage Funding*, *THE WALL STREET JOURNAL*, A12, 7 March 2008.

¹⁵⁵ Bert Ely, *Let's Try Market-Oriented Reform*, *THE WALL STREET JOURNAL*, A11, 31 May 2008.

¹⁵⁶ See Deborah Solomon, *U.S. Pushes a European Method To Help Banks Make Home Loans 'Covered Bonds' May Lure Investors Wary of Defaults*, *WALL STREET JOURNAL*, A3, 17 June 2008. Solomon notes that “Some analysts have predicted that a covered-bond market in the U.S. could grow to \$1 trillion over the next few years. Currently, the market is minuscule compared with the \$11 trillion in home mortgages outstanding in the U.S. ...Covered bonds

them as a solution.¹⁵⁷ They were said to offer the "double protection of on-balance-sheet status" and a "cover pool of high quality mortgages."¹⁵⁸ The credit ratings of such bonds would be higher, and interest payments accordingly lower.¹⁵⁹ Focus was also brought to bear on the bondholder's prime ranking against bank assets in the event that underlying mortgage assets did not cover a claim.¹⁶⁰ In July 2008, the FDIC issued a statement¹⁶¹ supporting the expansion of a covered bond market in the United States.¹⁶²

The UK Treasury has been working for some time to implement legislation to allow for covered bonds in accordance with the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive.¹⁶³

Some regulators remain wary of cover bonds and related products since pledging balance-sheet assets to investors (bond purchasers) may "undermine the first preference [that] . . . should be given to depositors in the event of a bank failure."¹⁶⁴ This debate continues.

F. Conclusion

The authors of an IMF Working paper released in 2007 have summarized the benefits of covered bonds as follows:

First, covered bonds help credit institutions gain access
to an alternative stable and relatively cheap funding

are considered safer investments because they stay on a bank's balance sheet and the buyer of the bonds gets double protection. The bonds are backed first by a "cover pool" of high-quality mortgages that must meet certain criteria, such as being in good standing. If the mortgages go bad, the bank must step in to ensure bond holders get their interest." *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *See id.*

¹⁵⁹ *See id.*

¹⁶⁰ *See id.*

¹⁶¹ Press Release, Federal Deposit Insurance Corporation, Federal Deposit Insurance Corporation on Covered Bond Policy Statement (15 July 2008), *available at* <http://www.fdic.gov/news/news/press/2008/pr08060a.html> (last visited Feb. 3, 2009).

¹⁶² Heidi N. Moore, Deal Journal – Path to Cash: Covered Bonds - FDIC Urges Banks to Issue Securities; Huge Market in Europe, *THE WALL STREET JOURNAL*, 17 July 2008, C3.

¹⁶³ HM Treasury Press Release, 120/07, 8 November 2007, Government to implement covered bonds regime in March 2008. For the relevant Directive see 85/611/EEC.

¹⁶⁴ David Uren, Mortgage bundling supported, *THE AUSTRALIAN*, 24 June 2008, p.23, discussing the approach of the Australian Prudential Regulation Authority (APRA).

source in an environment of increasing reliance on wholesale funding as opposed to a core deposit base.

Second, small regional credit institutions have the possibility of “club” funding. Through joint-issuance of a covered bond, small institutions can access international capital markets, typically only available to medium or large financial institutions. The mortgage pool may enjoy further credit enhancement as a result of the regional diversification of the underlying mortgage portfolios.

Third, similar to other instruments, such as credit and interest rate derivatives, covered bonds allow for better long-term liquidity management and the matching of the increasing duration of assets with long-term bonds.¹⁶⁵

It is submitted that German *Pfandbrief* offers a ready model for foreign regulators looking to shore up capital markets and re-launch a culture of responsible lending.

¹⁶⁵ Renzo G. Avesani, Antonio García Pascual & Elina Ribakova, *Appendix II: Regulatory Framework for Pfandbriefe and Cédulas Hipotecarias Mortgage Pfandbriefe: A New Regulatory Framework in The Use of Mortgage Covered Bonds*, 20, IMF Working Paper, WP/07/20 (2007). This Working Paper does not represent the views of the IMF.