THE FINANCIAL CRISIS:

STRESS-TESTING THE PFANDBRIEF

Attendees

From left to right

Jörg Homey, AVP analyst, Moody's Investor Services

Jens Tolckmitt, executive director of the Association of German Pfandbrief Banks (VDP)

Daniel Rauch, fund manager, Union Investment

Andreas Schenk, managing director, Treasury, Deutsche Pfandbriefbank

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SETTING THE SCENE

DANIEL RAUCH, FUND MANAGER, UNION INVESTMENT:
Definitely the important issue today is transparency and everything which tends to frustrate transparency. We are now seeing a new set of changes in the German law, the new amendments to the *Pfandbrief Act*. It is a detailed process and is being conducted in a way that laws should be modernised; being regularly updated. However, the process is never ending and there are other proposals now emerging, particularly in combination with the work of the Covered Bond Investor Council, which is funded on a European basis. Among the key initiatives in this regard is the establishment of a transparency working group, which is a welcome prospect.

JENS TOLCKMITT, EXECUTIVE DIRECTOR, THE ASSOCIATION OF GERMAN PFANDBRIEF BANKS:
As an industry body, our principal concern is to take all measures needed to ensure that the benchmark status that Pfandbrief has in the covered bond market (but also in the broader capital market) as a safe investment is secured for the future, both over the medium and long term. A current issue is obviously the amendment of the *Pfandbrief Act* that has recently been published. Another very important element is the renewal of the Jumbo Minimum Standards. Some kind of real commitment has to be in place to ensure both market making and post-trade transparency. Finally, we are working intently on increasing transparency for the product itself.

JÖRG HOMEY, AVP ANALYST, MOODY'S INVESTOR SERVICES:
As everyone has mentioned, transparency is key in the current market. We have observed that the number of investors calling us directly has increased significantly over the last year. Therefore, in this context, we believe that Moody's, as a rating agency, can provide added value by answering questions about the credit quality of the collateral, refinancing or structural risks. We believe that we have played an important role in encouraging issuers to disclose the pool composition of covered bonds and we have been able to provide homogenous information. We have started to publish quarterly performance overviews on covered bonds and this is something which we believe will benefit the market. With respect to the currently discussed changes to the German *Pfandbrief Act*, Moody's views the new Pfandbrief Act amendments positively as a mitigant to address refinancing risk.

ANDREAS SCHENK, HEAD OF TREASURY, DEUTSCHE PFANDBRIEFBANK:
The challenges and the priorities are perhaps a little bit different for us. Deutsche Pfandbriefbank re-established itself in the capital markets in the second half of last year. We are now trying to increase our issuance volumes and our standing in the market. That puts us in a special situation. If I look at the overall Pfandbrief market I agree with the rest of the panellists on transparency; and we can always continue to improve. Looking back, I think that the Pfandbrief has proved to be a stable funding instrument for banks even during the crisis compared to many other markets, particularly other covered bond markets. We definitely believe in the Pfandbrief product and we are building our business model on it.

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JENS TOLCKMITT: I think the Pfandbrief passed this real stress test quite impressively. For the first time, really, its overall framework was tested and it was tested successfully, particularly compared with its peer products in Europe, which did not perform as the Pfandbrief did. However, and this is an important point, at the Association we don't think we can now lean back and be complacent. On the contrary, we are underscoring the quality of the Pfandbrief and at the same time looking at the challenges ahead and putting everything into improving the quality of the Pfandbrief in order to make it even more resilient against future challenges or crises. I think what was an interesting development was that investors remained with the Pfandbrief all through the crisis. Now, in the post-crisis environment, a number of banks are looking at the Pfandbrief as an additional funding instrument. I think many institutions have come to realise that the only instrument that offered access to liquidity in extremely difficult times, or almost all the time, was the Pfandbrief. I would therefore go as far as to say the Pfandbrief is a kind of winner from the crisis.

FRANCESCA CARNEVALE: Andreas, over the period of the crisis were you reassured by the actions taken in shoring up the Pfandbrief infrastructure? Separately, as an issuer, do you have to do a lot more in terms of the cover pool, to improve investor appeal in the product?

ANDREAS SCHENK: It is a bit difficult for me to judge because out of our particular situation. We had to do much more than other issuers given our recent history and what happened during the crisis with Hypo Real Estate Group. We definitely had to re-establish ourselves in the market and do a lot of work in this respect. The important thing is that you re-engage in a dialogue with investors. However, we also learned a lot from this situation, we applied this new knowledge and we now have many more investors we can approach. In fact, there are many more names in the order book. Maybe in the past the spreads were not sufficient for some investors, maybe they considered the market unattractive. The good news is that many more investors are interested in the Pfandbrief market.

DANIEL RAUCH: I need to go back to explain a little the steps in our investment process, how we evaluate and analyse credit and the covered bonds we invest in. We do a lot of number-crunching and have done for some years. The analysis always starts with the bank, on an unsecured basis; after all, it is an obligation of the bank itself. Then the next steps include analysis of the cover pools, the regulatory framework and so on. We have not changed our requirements, but we have been more focused on the analysis of the deals and that in turn puts more onus on issuers in terms of what they are providing. If you look at different jurisdictions outside of Germany, there is still a lot of a kind of unwillingness"to deliver". I think in the case of Germany, you have had this teamwork involving a strong association, which worked closely with its members and investors. In other jurisdictions this was not the case. That teamwork and the presence of a strong association have put Pfandbrief way ahead in this regard.

JÖRG HOMEY: Issuers seem to be committed at looking at ways they can address post-crisis demand in order to protect covered bond investors. As a consequence, issuers have been willing to provide more support to protect credit ratings. The primary stress on covered bond ratings has come from the fall in the senior unsecured ratings of the banks supporting the covered bonds. Moody's methodology involves a linked approach where the credit rating of the issuer itself is an input for our covered bond rating. If the issuer's own rating is under pressure, that certainly puts pressure on the covered bond rating. However, an issuer may be able to offset the negative rating pressure by adding further collateral to a cover pool.

ANDREAS SCHENK: The issue we have with ratings, and I am not talking about any agency in particular, but about rating agencies in general, is that over the last year ratings approaches changed a couple of times. In fact, at times it was pretty difficult for issuers and investors to follow the different rating approaches. Moreover, different agencies may view the same deal differently. Other times, the ratings agencies would change their minds about what was important and what was not. Therefore it was not an easy time reacting to changing methodologies or matching up the different ratings between agencies. The last few months have been particularly difficult in this regard.

JÖRG HOMEY: I see your point; however, please note that Moody's covered bond methodology has been robust since we published it in June 2005. We have not changed our methodology. We have always stated that there is linkage between covered bond ratings and issuer's ratings, mainly due to the uncertainty surrounding refinancing and liquidity risks upon issuer default. Before the crisis we had made our position clear in this respect. We had already explained to the market that refinancing risk cannot be measured with sufficient confidence for us to achieve our highest rating levels without highly rated issuers supporting the covered bond programmes.

DANIEL RAUCH: I think now it's up to the investor to say something about different rating approaches. Pretty much you're talking about three rating agencies with different approaches and the trend towards the big picture in the way they rate issues is streamlined nowadays and, actually, we welcome this development. However, it does make it rather difficult to dig into the details of an issue. You might have a pure academic view of what is the perfect Pfandbrief or covered bond; but that view might not actually gel with what an investor would like. For example, in non-German jurisdictions we have the option of issuing soft versus hard bullets. We don't have that option in Germany. Now I might understand that a soft bullet has its benefits and a ratings agency will appreciate those benefits. However, as an investor we have a preference for issues coming to market with a hard bullet.

DANIEL RAUCH, fund manager, Union Investment.

THE PROBLEM WITH RATINGS AGENCIES

FRANCESCA CARNEVALE: At times over the past year, the VDP [Verband Deutscher Pfandbriefbanken, the Association of German Pfandbrief Banks] has been very vocal over some of the decisions of the rating agencies, such as changes in methodology, the downgrading of some of the banks by Fitch, for instance. Are those tensions still in place?

JENS TOLCKMITT: To a certain extent, yes. There are a number of problems. One is procedural; that is, the question of whether and how a rating agency utilises required information. Historically, in many countries there are clear laws, procedural processes and guidelines in place, explaining clearly the information required of a publicly-listed company and the way they are published, particularly given that both the information and the issues are market-sensitive. I'm really concerned that this is not the case for rating agencies. There is a possibility for a rating agency to undertake a consultation process for more than ten months and obviously shaping market opinion on a certain product, or a group of products in that process. Then, they can overturn their approach and come up with a final version that might be substantially different from the first draft; but by that time it is too late, as market opinion has already been conditioned. This is a very big concern going forward. The second aspect is, and this became clear during the crisis, how difficult it is to measure precisely the inherent strength of a Pfandbrief by standards that are not necessarily measurable. I am thinking of say, the differences between securitisations and structured finance *per se* and Pfandbrief that ultimately might raise the rating of a Pfandbrief; or external legislative factors. It is not clear how these soft factors are calculated into ratings and how they are calculated between different jurisdictions. There is an influence but what the exact influence is, is not clear. I always have the feeling that, coming from a structured finance background, it's difficult to understand and difficult also to build into the models that there are other security or safety features within a legally-based product than there are in contractually-based securitisation transactions.

JÖRG HOMEY: It is difficult to translate certain soft factors into hard, quantitative, measurable factors. However, I will give you examples where Moody's is giving benefit within our analysis to the strong commitment of the German Pfandbrief community and the support by the German covered bond issuers to the Pfandbrief product. Looking at the law you mentioned, I just want to highlight two facts. One is the present value test, which includes a 2% over-collateralisation in stressed environments, and, secondly, there's a 180-day liquidity requirement. Both can be factored in by way of how we look at the market stresses to which the covered pool is exposed after issuer default. That is something we can indeed quantify in our models. So, you get a benefit there. There are more soft factors, as you mentioned, like public support from the government for instance, which is something that Moody's takes comfort from and we therefore apply less refinancing stress on a German Pfandbrief, compared to other covered bond market segments in Europe. You can see an example of this in our recently re-published covered bond rating methodology, where we mention some of the refinancing margins we apply in different markets. It clearly shows that refinancing margins which we apply for Pfandbriefe are among the lowest across Europe. So the strong expected support and the strong value of the Pfandbrief brand have been incorporated into our analysis.

MARKET DATA INITIATIVES

DANIEL RAUCH: We put high value on such reports but not in terms of the German market where there are strong transparency requirements or laws. It gives us much more value when we look outside Germany and move into other jurisdictions because the degree of transparency in some cases is much lower and therefore such tools, in our view, are highly welcomed. In this respect we put a lot of value on it. We would rather ask the association to think about maybe contractual amendments to what further information can be provided by issuers and the market itself. Can we, for instance, have detailed data on the LTV [loan to value] distribution? We could maybe have margin data on other covered bond jurisdictions. That, actually, is really valuable information that we would really like to have. Equally, what we really like in the new amendment to the *Pfandbrief Act* is the requirement for the delivery of timely information. Perhaps the VDP could add a database of this type of information for its members on its platform.

ANDREAS SCHENK, managing director, Treasury, Deutsche Pfandbriefbank

JENS TOLCKMITT: I have good news for you. On the timeliness issue, as you may have seen, the draft of the new amendment also foresees a deadline for publishing required data. It is published quarterly and the new law allows for a deadline of one month until the data is published; the only exception being the last quarter of each year, where data must be published within two months. Secondly, regarding market transparency, Paragraph 28 of the *Pfandbrief Act* was introduced because investors would benefit from such a standardised reporting framework. VDP worked closely with investors and other market participants to get it right. Our aim is to increase the market knowledge of investors and provide them with sufficient data to make them less dependent on ratings agencies. Actually, this is what investors want, to be able to make up their own mind as to the attractiveness of issuers. They want to make up their own mind whether they like a certain business model or they like a cover pool and so on. The thing is, it is difficult to marry all the different views of investors. There is not necessarily consistency in the range and depth of information required by different firms. If there was firm demand for particular information we would aim to provide it. As the industry association we have worked closely with our members to arrive at a broad understanding of the precise requirements laid out in Paragraph 28 of the *Pfandbrief Act*. In autumn this year, VDP will start to provide all member banks' individual data on its website based on this common understanding. This is a milestone for issuers and investors to have one point of access, consistency in presentation and common definitions of what is included. Moreover, data will be provided in a format that allows users to work with the data in their own spread sheets. Finally, VDP continues looking for consistent themes and requirements among investors and strives to comply with them as soon as possible.

ANDREAS SCHENK: This is a very important development. Many of the international investors are not fully aware of the fact that we have one common reporting standard, defined by law. If you add the database to this standard, it will set the market apart. If you have a look at other covered bond jurisdictions, everybody's reporting something but it's not to the same standard. Then you have the problem of comparing the figures, as they are often defined in multiple ways. Consistency is really important for us as an issuer. Therefore, in that context we are committed to working with the association and investors on improvements in this area. However, as a bank it's also important that we really stick to this information. We really want to stick to one set of information rules and range, which every investor has access to in the sense of fair disclosure.

DANIEL RAUCH: There is an interesting point here. Marrying the requirements of a wide range of investors was the starting point for the foundation of the Covered Bond Investor Council. There are still many investors that are not members, however principal investment firms have signed up to it; including us. Within the Transparency Working Group we have worked on a kind of a template, and we are still working on it, to have a common form for information which most of the market participants can work with and draw value from. Our chairman has presented various ideas on how the template would look and work, so perhaps we should, together with the chairman of VDP and other national associations, discuss these emerging formats.

FRANCESCA CARNEVALE: For the benefit of readers unfamiliar with German regulations, could you please define Paragraph 28?

JENS TOLCKMITT: Paragraph 28 of the *Pfandbrief Act* governs Pfandbrief banks' regular disclosure requirements. It caters for the group's transparency, the basis of which was laid back in 2004 in the last amendment of the former Mortgage Bank Act. It prescribes a number of disclosure obligations for Pfandbrief banks regarding both cover pool and the set-up of the cover pool and the funding side of their business, basically. So, based on Paragraph 28, the data will be compiled and aggregated on the VDP website in a usable format and based on common definitions. My understanding is, as I said, that many investors think that, as a first step, consistency in reporting is more important than the provision of additional information. What we don't want to do is end up with more information than is useful.

DANIEL RAUCH: There's a fine line, definitely, between what is also workable. How much data can you really handle?

JENS TOLCKMITT: It's especially small investors, and it's them who are telling us so, who really work under certain restrictions and have to be provided with the truly important information. It is especially with a view to this group that the initiative is aimed at, maybe even more than big institutions. So, yes, there is a certain limit in what everyone can actually process internally.

ANDREAS SCHENK: That's really important. You just have to look at the profile of Pfandbrief investors. The big firms usually take the benchmark issues and Jumbo Pfandbrief; those firms might be German or foreign. Then there are the private placements with many smaller investors. These investors are very important for us and while we are keen to provide them with as much information as possible, we have to understand that they might not have a big credit department or several analysts just focusing on covered bonds. It might be one, and he might be covering a multitude of investible products. We must be careful not to overload this important segment.

JÖRG HOMEY: In fact, we are publishing LTV distributions for mortgage covered bond transactions rated by us. Obviously not all covered bonds in Europe are rated by Moody's, so the universe is not complete in that sense, but at least for the universe we do rate (I believe there are over 180 covered bond programmes that carry our ratings) we provide a means of comparing cover pool data.

DANIEL RAUCH: One final point: it is up to the issuer to provide this information and not a third party. At the end of the day, the Pfandbrief is a direct interaction between an issuer and an investor.

FRANCESCA CARNEVALE: Again, for the benefit of our readers, what are the key features of the latest amendment?

JENS TOLCKMITT: The amendment basically addresses two aspects, centred on the so-called cover pool administrator who manages the cover pools and respective Pfandbrief liabilities after a Pfandbrief bank has become insolvent. In the end the *Pfandbrief Act* may be seen as a special insolvency law that centres on what happens if something goes wrong with the issuing bank. The amendment clarifies the legal status of the cover pool administrator after insolvency of an issuing bank, for instance, retaining partial bank status that enables him to act more flexibly in the management of cover pools than before. For international investors especially, it makes clear that contrary to some other jurisdictions, in case of insolvency of a Pfandbrief bank, all cover pools are explicitly taken out of the insolvency estate of the bank. That is simply for explanation, but it is an important difference to other jurisdictions where investors in covered bonds have a preferential claim but within the insolvency estates of the bank. In our case, cover assets are exempt from the insolvency procedures and they will retain a partial bank status. Cover assets are administered like a going concern. Secondly, the amendment gives the administrator the ability to raise bridge financing externally and bring in liquidity from outside by issuing Pfandbrief. By that, liquidity may be provided over the whole life of the pools.

TIERED MARKETS IN COVERED BONDS?

FRANCESCA CARNEVALE: Do you think that the quality of the underlying regulatory regime will mean that much of the covered bond investor market will coalesce around the Pfandbrief, preferring it over other jurisdictions?

JÖRG HOMEY: It's a good question. Covered bond products differ country by country and legislation by legislation. That's a fact that always was and always will be the case. Over the last few years many cover bond products came to the market and market participants are innovative. That is actually the function of a market, to provide innovation. However, we would be careful about making sweeping generalisations. Within each country there are marked differences on the credit quality of cover pools and the issuers. Furthermore, a number of covered bond markets have performed strongly over the crisis. In summary, while we expect to see a varied and diverse market going forward, we do not believe we will see a simple "two-tier" market with the Pfandbrief on the one hand and all other covered bonds on the other.

JENS TOLCKMITT: I don't see a two-tier market, also because there are so many factors to be looked at. It's not just about quality; it's about liquidity and so on. However, throughout the crisis we have seen that for the first time in a long time there was differentiation in spreads, which suggests a certain view of the market on the inherent quality of the different products. That has not led to a two-tier market but to a multi-tier market. The interesting thing is that before July 2007 spreads were very close to each other, no matter which jurisdiction was behind it, and that changed after the first signs of crisis in 2007 and after Lehman Brothers' collapse when spreads widened tremendously. We thought as a consequence of the ECB Covered Bond Purchase Programme there would be a certain risk that covered bond spreads will tighten back to pre-crisis levels. That has not happened for most products. Since October last year we observe the persistence of covered bond spread differentiation that I think will remain. Secondly, domestic and international investors confirm there is a certain kind of division in play, at least for now. They explain that the Pfandbrief and some other products enabled them to get out of positions even during the crisis at any time, which other products did not. Finally, the challenge, I think, is coping with the spreading of the covered bond idea to new countries and potentially new asset classes. When I look at the US, for example, they are definitely getting serious about the introduction of covered bonds. In terms of new asset classes, the inclusion of student loans and credit card receivables in the US *Covered Bond Act* could perhaps lead to a further tiering of the market. It is something we follow closely.

HARMONISATION OF THE EUROPEAN COVERED BOND?

FRANCESCA CARNEVALE: Given some of the problems that some structured products faced across Europe, what cross-border efforts are in place to ensure consistency and the robustness of security packages and covered pools, for instance? In Europe, do you think that the market thrives on that difference rather than seeking harmonisation?

DANIEL RAUCH: The first point I would like to make is the branding of the covered bond and I definitely agree with the association because I can remember times in the beginning of 2007 where I had several meetings with innovative investment banks about what the covered bond should look like. We gave clear guidance of what we required. However, it conflicts with the terms that we are seeing in the first drafts coming out of the US. For us it is important that the collateral needs to comprise of something which has, let's say, economic importance for the country. Now, you can discuss student loans and auto loans and car loans, and the different degrees of their economic importance, but in Germany right now we are limited, really, to the housing market and to the public debt segment. That gives potency to the brand; but it is an issue when we talk about moving the product globally or internationally. In terms of harmonisation, it does exist in terms of the fact that we have more and more legal-based regulation. Now, you can discuss the different degree of the quality in these jurisdictions, that's a fair point, but at least the direction is there. I think harmonisation is on its way, but now you have to discuss whether it is large scale harmonisation or small scale. Here I agree with Jörg that we will always have national specifics and not a completely homogenous product which is called covered bonds and which have similar requirements in each country.

JENS TOLCKMITT: I don't really believe that we will have harmonisation for the same reasons that were mentioned—too many different systems with too many different details. I don't really know whether we would want harmonisation in the real sense because the advantage of the current multitude of products is that there is competition between different systems and elements within different systems, and such competition will really enhance the overall quality of the covered bond. As difficult as it may be to find a common covered bond label, the idea of it is to at least define the *status quo* in Europe, what we see as a covered bond also with a view to EU legislation. This is of value and I understand it is also a value for investors (from the CBIC again) that the industry has a common understanding of what a covered bond is and what future covered bonds should look like if they want to belong to this group. However, that is very far from harmonisation. It's simply about finding agreement on some very high-level criteria.

ANDREAS SCHENK: If we had only one covered bond, I think it would be also a compromise of the lowest common denominator. From an investor viewpoint, a variety of products is always an advantage because they have choice. There is also disagreement over what is the best covered bond format. The driver is investor choice: if I offer a product which nobody wants to buy, then I have to increase my spread. It's getting more expensive and therefore it's a natural way that the market culls the least effective structures and it is perhaps the most efficient.

NEW ISSUES

FRANCESCA CARNEVALE: What is the outlook for new issuance in 2010?

DANIEL RAUCH: There's a statement from the CBIC which I'd like to mention. We've noted in the last couple of issues, beginning in 2009, that primary deals are coming to the market while using so-called IOI shadow books: essentially pre-soundings. There were benefits: it helped investors, it helped smooth the markets and it helped government interventions. Now that we have more stable markets, I think that if you have a decent syndicate or originator, then we no longer need these pre-soundings, because actually, in the end, it causes a lot of confusion. So we and the CBIC are hoping for a change there. Elsewhere, public sector covered bonds are on a diminishing curve, so much more residential or commercial-backed covered bonds will come to the market. Moreover, a number of universal banks are now exploring ways to harness the Pfandbrief as a natural part of their funding strategy. That's a big change, as in the past only specialist banks moved in this market.

ANDREAS SCHENK: If you look at new issuance you also have to look at maturity profiles. I think we will see more mortgage Pfandbriefe and mortgage covered bonds in general. On the other hand, looking at the maturity profiles, particularly with regard to public sector covered bonds; the question is how much supply we will see at various maturity levels. Deutsche Pfandbriefbank will concentrate on originating new business in the public finance and real estate finance area. Buying secondary market bonds, adding them to the collateral pools and issuing Pfandbriefe against it will not work going forward. The focus will be on self originated business, also of smaller loans. I agree that the issuance on the market will be less. Taking the maturities into account and this year's specific situation, it may turn out to be an asset class where there's more demand than supply. Coming back to pre-sounding, I agree that this was overdone. It was also very difficult for either smaller investors or investors who were not part of this pre-sounding process to be part of the book. It's reasonable that you have a pre-discussion with a selected group and perhaps your main investors. More and more we will do this ourselves rather than through a syndicate in order to achieve a direct relationship also between the bank and the investor.

DANIEL RAUCH: There will be always communication from us as to what we would like to buy and at what maturities. We did this before the crisis and continue to do it, so I am not talking about having no communication at all.

JENS TOLCKMITT: I would like to add two points. The diminishing volume of public Pfandbriefe is not a result of the crisis. It is a process that has been going on since 2000, when the overall market volume peaked and it has been diminishing ever since more or less constantly. According to our estimates, the trend will continue this year. This is because the public sector business model is changing and it's less large volume tickets but more traditional loan business.

JÖRG HOMEY, AVP analyst, Moody's Investor Services

Actually, I think, it is positive for the product. So, this is a long ongoing process and it will continue. With regard to issuance, just to give some figures we estimate the overall issuance in Pfandbriefe this year to reach €100bn and the same is true for 2011. However, we will see a reduction in the overall market volume, according to our estimates, to around €700bn, down from €720bn. In 2011 we envisage redemptions and new issuance will balance out.

FRANCESCA CARNEVALE: Redemptions are much higher now, aren't they?

JENS TOLCKMITT: They are now higher, yes and that is why the overall volume has been diminishing for the last nine years.

ANDREAS SCHENK: But do your figures include private placements?

JENS TOLCKMITT: Everything.

ANDREAS SCHENK: That's very important because many other research papers only have benchmarks but not private placements.

FRANCESCA CARNEVALE: How much of the total will be Jumbo Pfandbriefe?

JENS TOLCKMITT: We have estimated the jumbo part at 25% to 30% of the overall volume, somewhat less than in the past, but if you look at the development of the product and also the lessons learnt from the crisis, then one comfort issuers had was that they could approach the market with smaller traditional issues that are easier to handle at any time. Moreover, registered issuance has proven to be possible at all times and more easily manageable than large redemptions at one point in time.

LOOKING TO THE FUTURE

JÖRG HOMEY: Our covered bond ratings are linked to the underlying issuer rating. In our methodology we have the timely payment indicator, in short, the TPI, which works as a cap for the covered bond rating. A TPI limits how many notches a covered bond can be rated above the underlying bank supporting the covered bond. The TPI cap reflects our opinion that a covered bond with an exposure to material refinancing risk should not have the highest possible rating if not backed by a highly rated entity. So, if the issuer rating is downgraded, then at a certain stage, depending *inter alia* on the structure of the covered bonds and the quality of the cover pool assets, the covered bond rating would start to migrate as well. At the start of 2010 the majority of the issuers supporting the covered bonds we rate either had a negative outlook or were on review for a possible downgrade. Against this background the overall outlook for covered bond ratings for the next year is negative. Another credit driver seen last year was refinancing risk. We believe that in 2010 refinancing risk will remain a volatile risk. However, rating actions due to the increased assessment of refinancing risk have been limited to date, in part due to support that has been forthcoming from issuers.

DANIEL RAUCH: There are several issues out there that will be solved in one way or another over the next couple of years. One big trend in Germany will be the questioning of some business models and the further survival of those models and how banks behave in future. I also imagine that the landscape that we are in right now in terms of which issuers dominate will definitely change. We will see much less public sector collaterals than we have, though this is not a really difficult forecast. I think there will also be more discussion around market-making and the sourcing of liquidity and how we can improve these processes. I also hope that post-trade transparency, which is currently in the pipeline, will finally find its way into the market.

JENS TOLCKMITT: I expect new issuers to come to the Pfandbrief market that want to access the market with regard to the value that Pfandbrief provides especially during difficult market conditions. I also expect the mortgage Pfandbrief to increase in importance in a more normalised market after the crisis and public sector issuance to diminish. As Daniel said, a key issue is market making and the question of post-trade transparency. It's fundamental to developing the product further. Although Pfandbrief is a long-standing product, it is the issuers' job to maintain it as an innovative product. At first glance Pfandbrief sometimes seems to look a little bit unexciting but, on the other hand, if you look at the developments that we have seen over the past two decades, in terms of the legal and market frameworks, the Pfandbrief proved to be quite innovative for the whole industry. We as issuers have to be clear that we can only differentiate ourselves if we keep such innovation going. With regard to post-trade transparency, we are working on a distinct kind of transparency and liquidity framework for large liquid issues. We are working on robust market-making standards where price indications will be quoted and transparency is provided on the quotes. So, this would be post-trade transparency, basically.

JENS TOLCKMITT, executive director of the Association of German. Pfandbrief Banks (vdp)

FRANCESCA CARNEVALE: Will there be a tape or board with all prices quoted?

JENS TOLCKMITT: That's work in progress, actually, but I think we have come a long way and maybe are further down the road than other jurisdictions.

ANDREAS SCHENK: There will definitely be volatility in many markets. I am convinced that the German Pfandbrief will be a market with lower volatility compared to other markets going forward. It is all very promising. We certainly will have some consolidation on the German banking side so that issuers will disappear, but new issuers will come to the market. The Pfandbrief market will definitely be one very, very big market in Europe and pretty stable compared to other markets.

JÖRG HOMEY: When the 2005 *Pfandbrief Act* was introduced, I believe it was also intended that it should facilitate the consolidation of the issuer landscape. What we have actually seen since then is a more diversified spectrum of issuer. I would expect that we will see some more diversification going forward, not only in terms of issuer but also perhaps in terms of cover pools. For example, Postbank is using its residential book as cover assets for its Hypothekenpfandbriefe while Deutsche Bank is using its commercial book. Furthermore, we have seen a trend whereby more international assets are added to the cover pools.