



# Covered Bonds in Europe Legal Structure and Transparency

**Curs de Crèdit Hipotecari**

**Barcelona – 15 May 2008**

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Association of German Pfandbrief Banks**



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## About vdp – Association of German Pfandbrief Banks



**VERBAND DEUTSCHER  
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The vdp is the lobbying organisation of Germany's Pfandbrief banks

- 34 member banks with a market share of 95 % of Pfandbrief outstanding (890 bn Euro) and 98 % of new issuance (2007: 135.4 bn)
- Analysis and permanent refinement of the Pfandbrief system in more than 20 committees and working groups of the Association
- Think tank for all aspects related to the Pfandbrief
- International Pfandbrief marketing



1. Capital market funding of mortgage loans and importance for development of real estate markets



# 1. Capital market funding of mortgage loans and importance for development of real estate markets

- funding of long-term mortgages



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**banking  
group  
funding**

- Equity (core capital)
- Subordinate loans (additional capital)

**stand alone  
market  
funding**

- Deposits: cheap, but maturity short term mismatch, risk of decreasing volume
- Interbank loans: short term → maturity mismatch

- Capital market

Unsecured bonds: low costs of issuing, but no specific rating, no special treatment on risk-weighting and investments

**Secured bonds:**



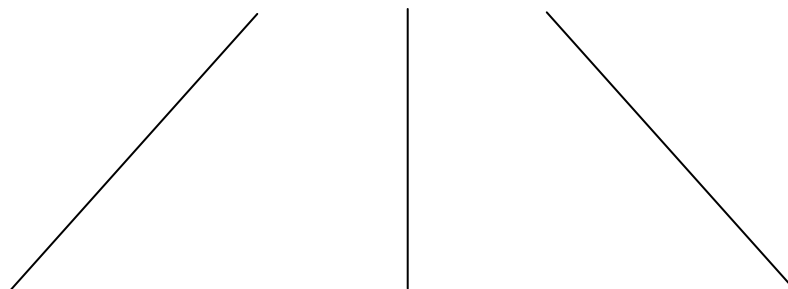
# 1. Capital market funding of mortgage loans and importance for development of real estate markets

- funding of long-term mortgages



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## Secured bonds



### **Covered bonds**

Cover assets

- on balance of originator
- issuer = bank

### **Structured Covered bonds**

- = CB
- issuer = bank

### **MBS**

- cover assets off balance regarding originator
- issuer  $\neq$  bank



# 1. Capital market funding of mortgage loans and importance for development of real estate markets

- funding of long-term mortgages



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## Pricing of Secured bonds depends on

### 1. Security

- Legislation
- Cover assets of the issuer

### 2. Transparency

- Of legislation and regulations of banking supervision authority
- Of the quality of cover assets
- Of the market
- Of the issuing behavior of issuers

### 3. Liquidity of the market

— Market making !

### 4. Currency !

Rating Agencies concentrate on 1., but also deal with 2.



# 1. Capital market funding of mortgage loans and importance for development of real estate markets

- funding of long-term mortgages



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## Pricing and Rating

Aim: ⇔ to achieve

***better*** pricing and rating for secured bonds than for unsecured bonds



depends on level of segregation and bankruptcy remoteness



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## 2. History of Covered Bonds in Europe



## Historic development of the „Pfandbrief“ (as of 4/2008)



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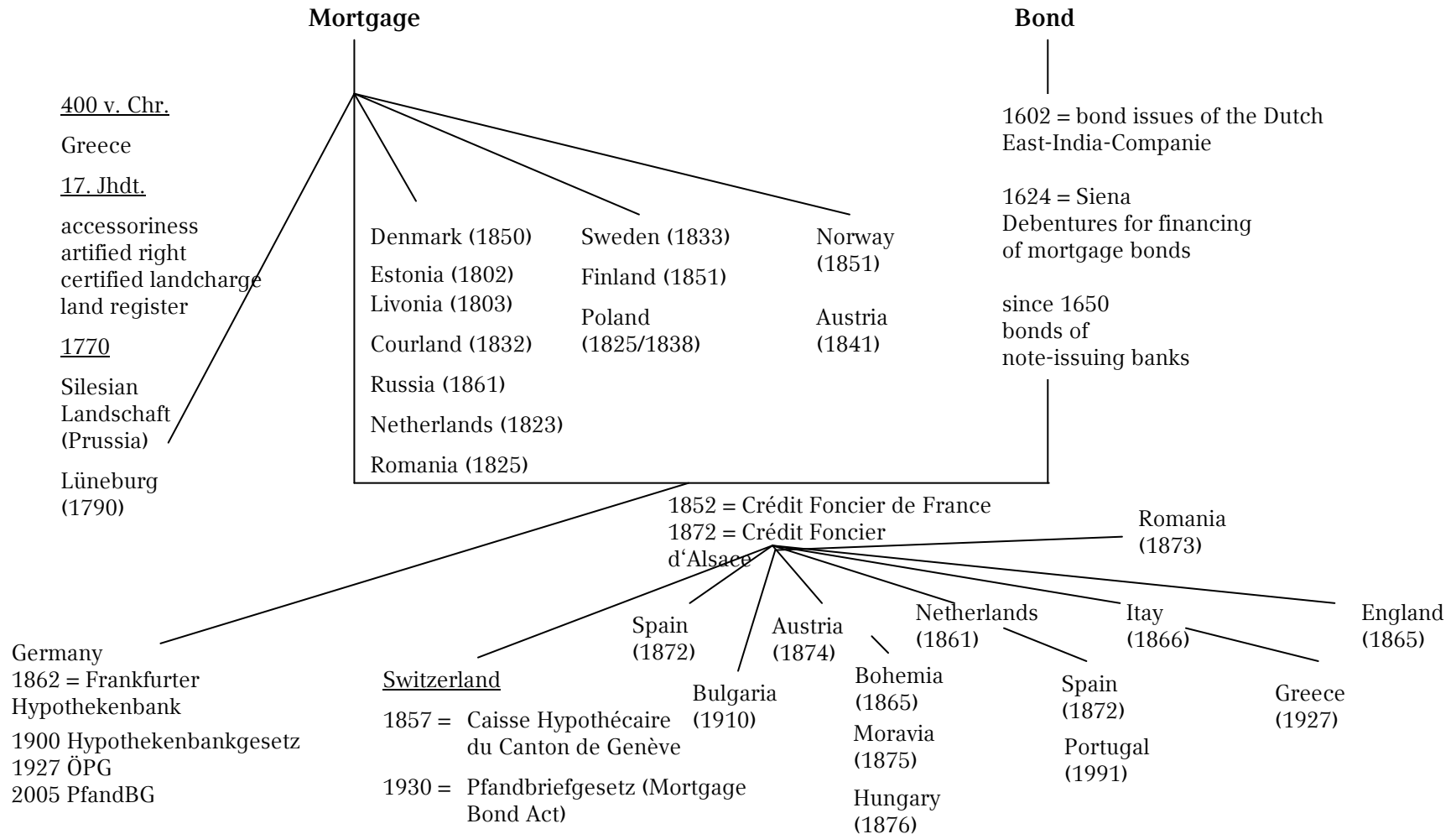
- 1770 Silesian Landschaft, Breslau
- 1825 Warsaw Landschaft, Warsaw
- 1830/31 Ludwik Wołowski to Paris  
- becomes professor of industrial economy  
- initiates legislation for CFF
- 1852 Crédit Foncier de France, Paris = 1. mortgage bank  
↓
- 1871 Preußische Centralboden-Credit-Actiengesellschaft,  
Berlin, (modern mortgage bank)  
↓
- 1893 standard provisions (rules for licensing) for prussian  
mortgage banks modernised by the example of the  
Centralboden's Charter  
↓
- 1.1.1900 the German Mortgage Bank Act (HBG) comes into force
- 19.7.2005 Pfandbrief Act



# Historic development of the „Pfandbrief“ (as of 4/2008)



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# Historic development of the „Pfandbrief“ (as of 4/2008)



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HBG 1900 /  
PfandBG  
2005

- Switzerland (1931)
- Austria (1938)
- Czech Republic (1995)
- Slovakia (1996)
- Hungary (1997)
- Luxemburg (1997)
- Poland (1928) - (1998)
- Latvia (1998)
- France (1999)
- Finland (2000)
- Ireland (2002)
- Lithuania (2003)
- Sweden (2004)
- Germany (PfandBG 2005)
- Norway (2006)
- Slovenia (2006)
- Portugal (2006)
- Denmark (2007)
- Turkey (2007)

Hybrid Structures  
(Covered Bond / MBS-  
Version) (specific  
cover pool for  
each issue)

- Bulgaria (2000)
- Russia (2003)
- Romania (2006)
- Ukraine (2006)

Structured  
Covered Bonds

*statutory basis*

Italy (2005)

Greece (2007)

UK (2008)

*contractual  
basis*

Netherlands

Iceland





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### 3. Covered Bonds in Europe – market shares

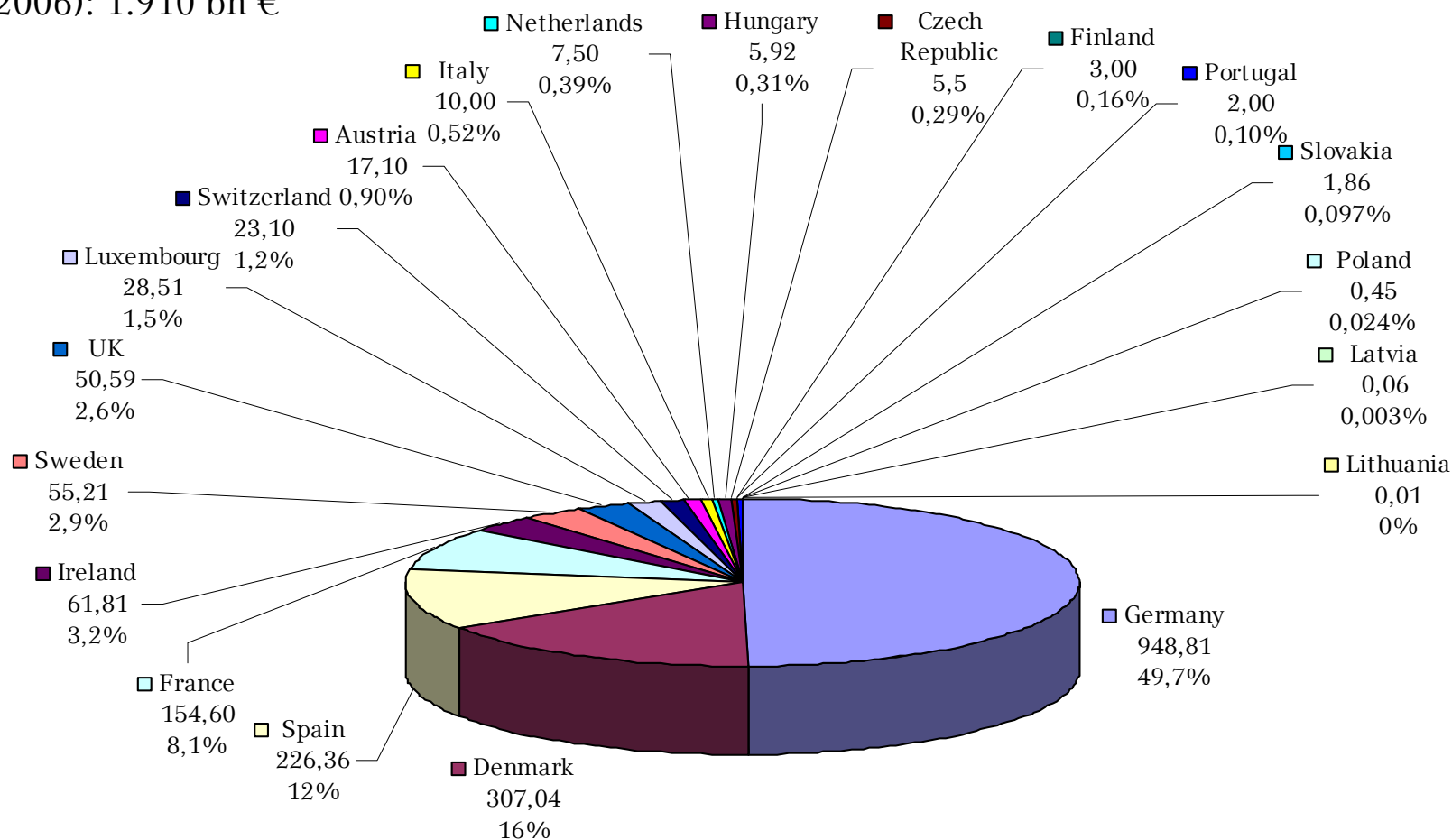


### 3. Covered Bonds in Europe – market shares



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Market Share of the European Covered Bond Countries in the European Covered Bond Market (end of 2006): 1.910 bn €



For Austria the figures are tentative.

(source: EMF/vdp – 27.7.2007)



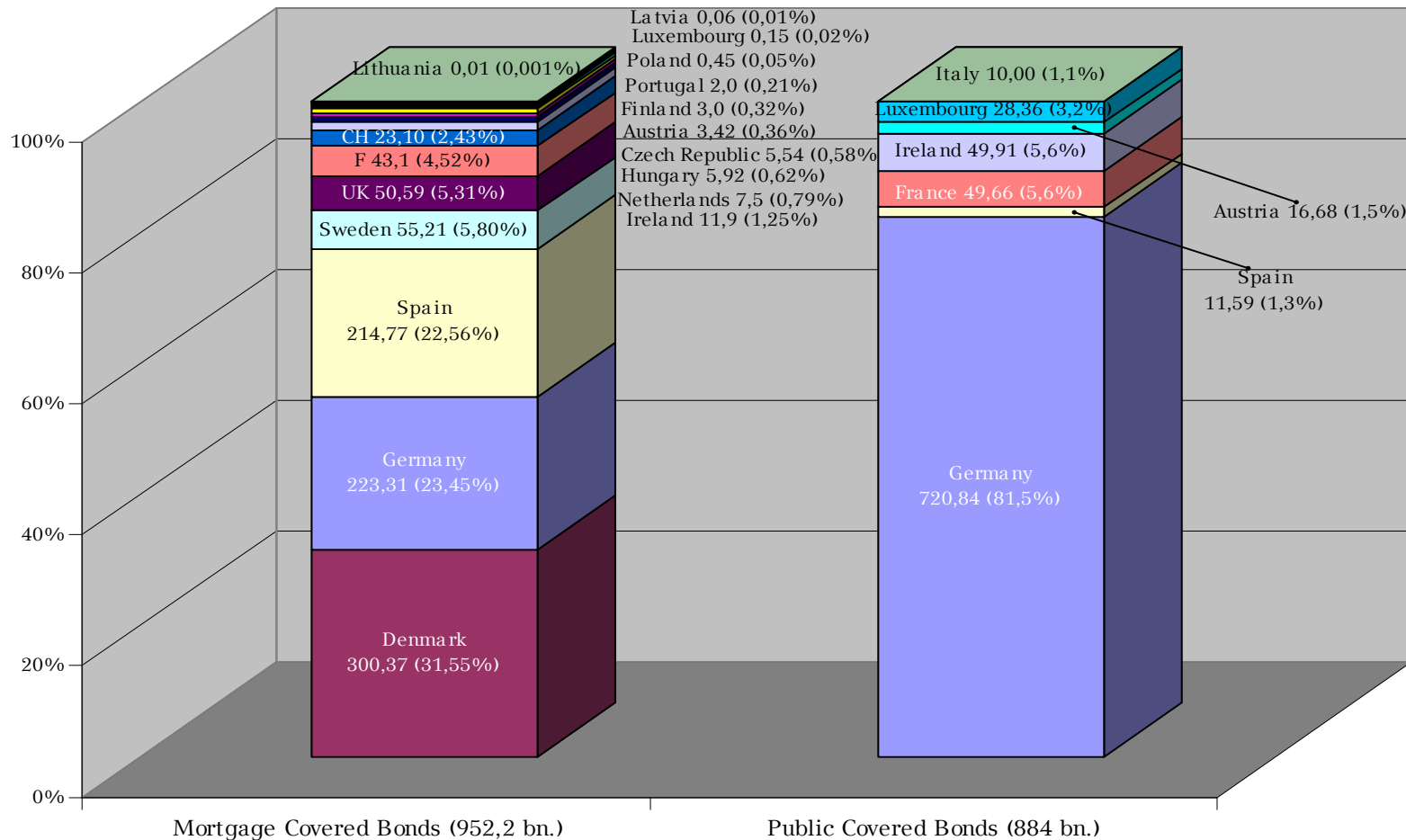
### 3. Covered Bonds in Europe – market shares



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Public Covered Bonds in the EU compared with Mortgage Covered Bonds (end of 2006, in bn. EUR)

(source: EMF/vdp –27.7.2007)



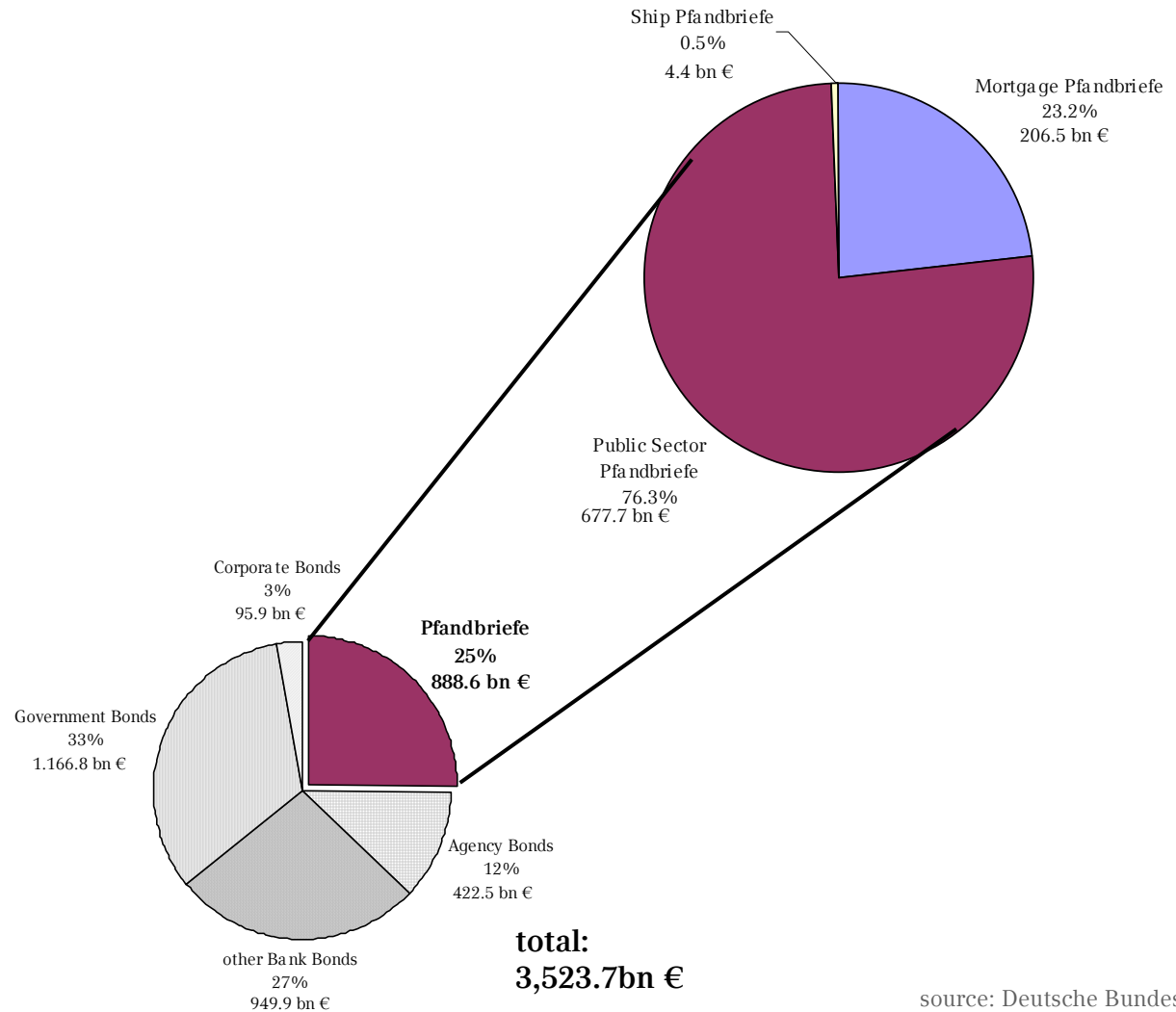


### 3. Covered Bonds in Europe – market shares



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Bonds outstanding  
in German fixed  
income market  
(Dec. 2007)



source: Deutsche Bundesbank

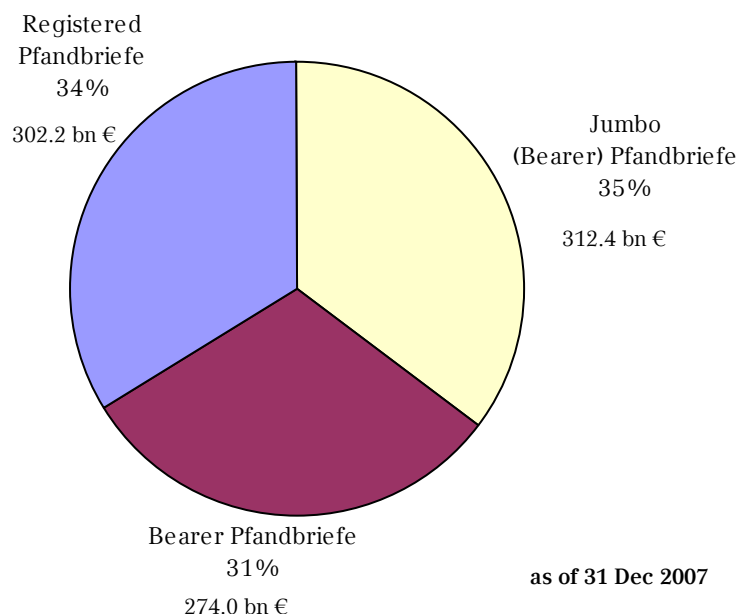


### 3. Covered Bonds in Europe – market shares



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Pfandbrief  
according to types  
of bonds  
(Dec. 2007)



#### Minimum Standards for Jumbo Pfandbrief (excerpts):

- Minimum volume 1 bn €
- Fixed coupon and bullet format
- Minimum of five Market Makers
  - quoting two-way prices
  - in tight, defined bid-ask spreads
  - for lots of up to 15 mn €
- Taps or add-ons allowed (minimum volume 125 mn €)

sources: Deutsche Bundesbank, UniCredit

#### Investor base

- Insurance companies, pension funds, investment funds, central banks, banks
- Strong domestic investor base
- Investors have different investment approaches
  - buy-and-hold investment vs. trading and relative value strategies



Reliable access to liquidity in any market environment through diversified investor base pursuing different strategies

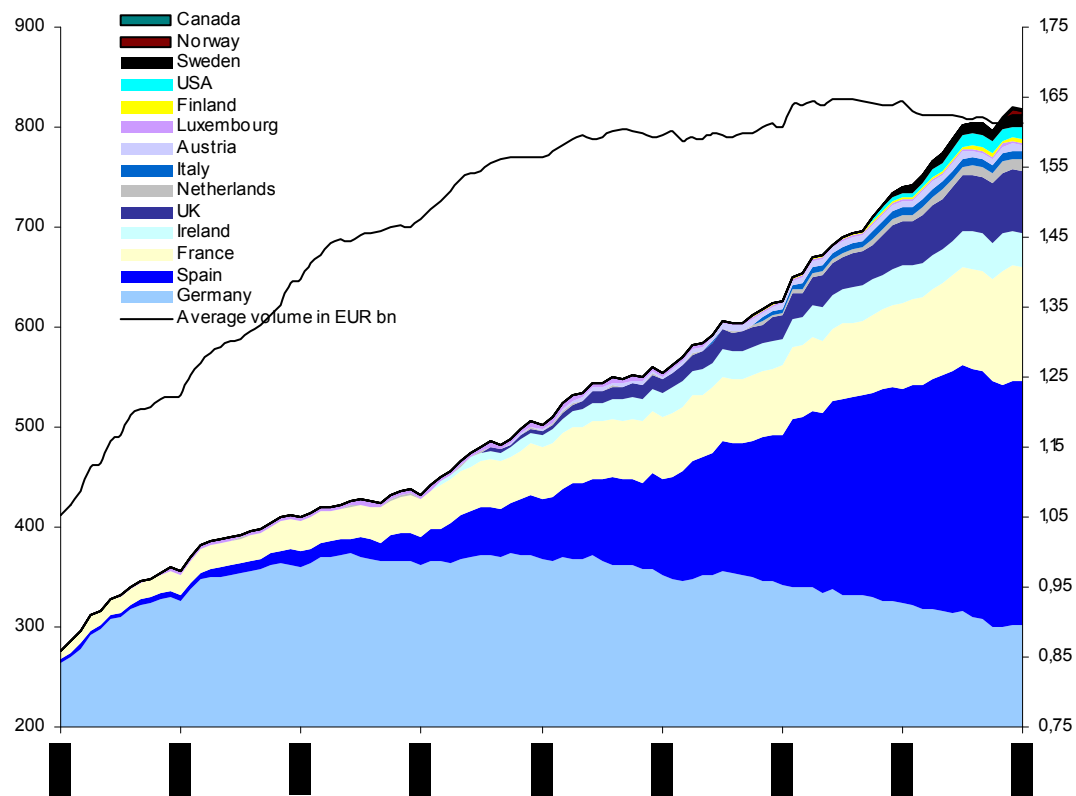


### 3. Covered Bonds in Europe – market shares



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## Ongoing Increase in Outstanding Volume of Jumbo Covered Bonds (EURbn)



source: DB Global Markets Research

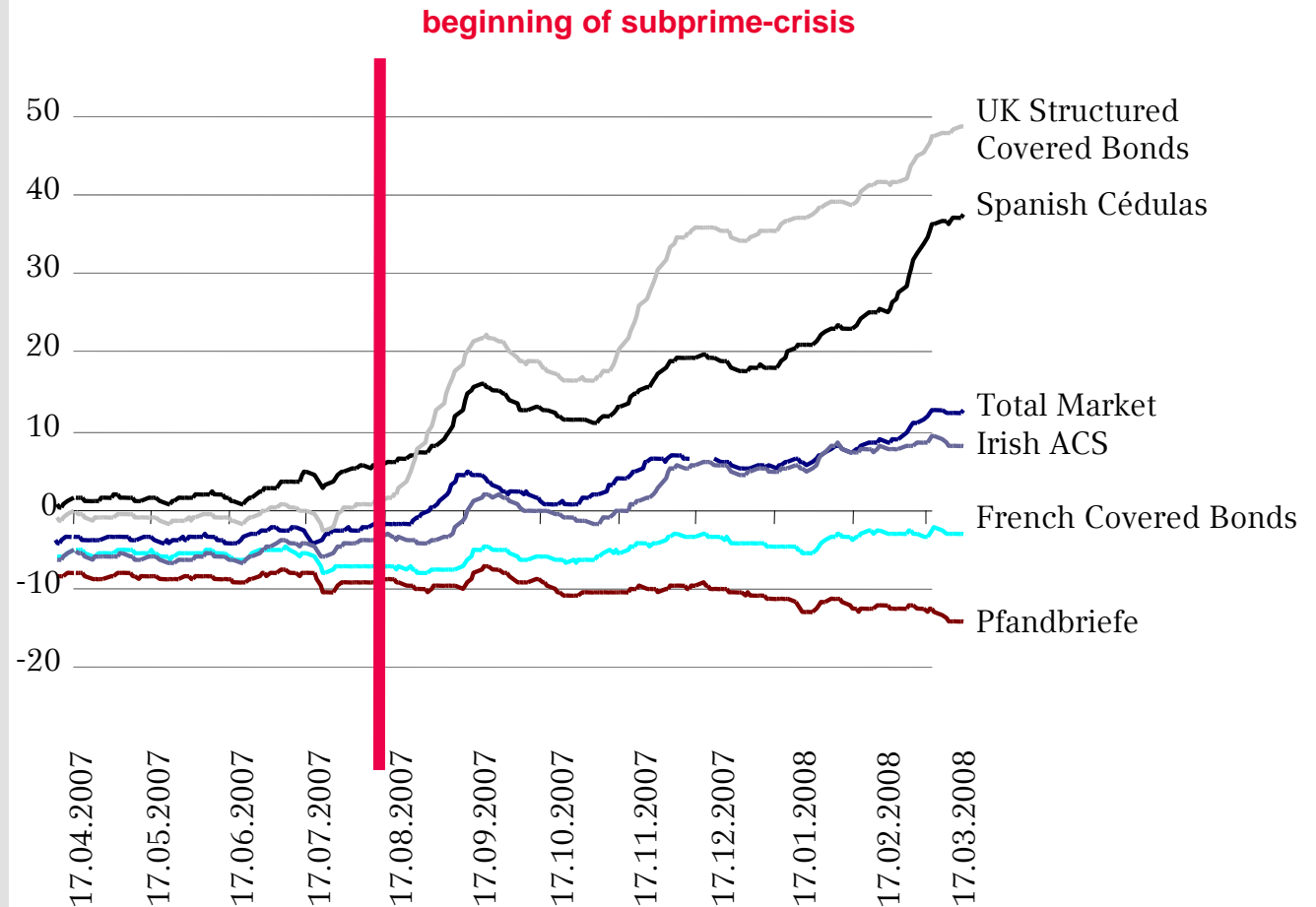


### 3. Covered Bonds in Europe – market shares



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Swap Spreads  
Covered Bonds



source: LBBW Credit Research, iBoxx



## 4. Covered Bonds in Europe – legal structures



#### 4. Covered Bonds in Europe – legal structures

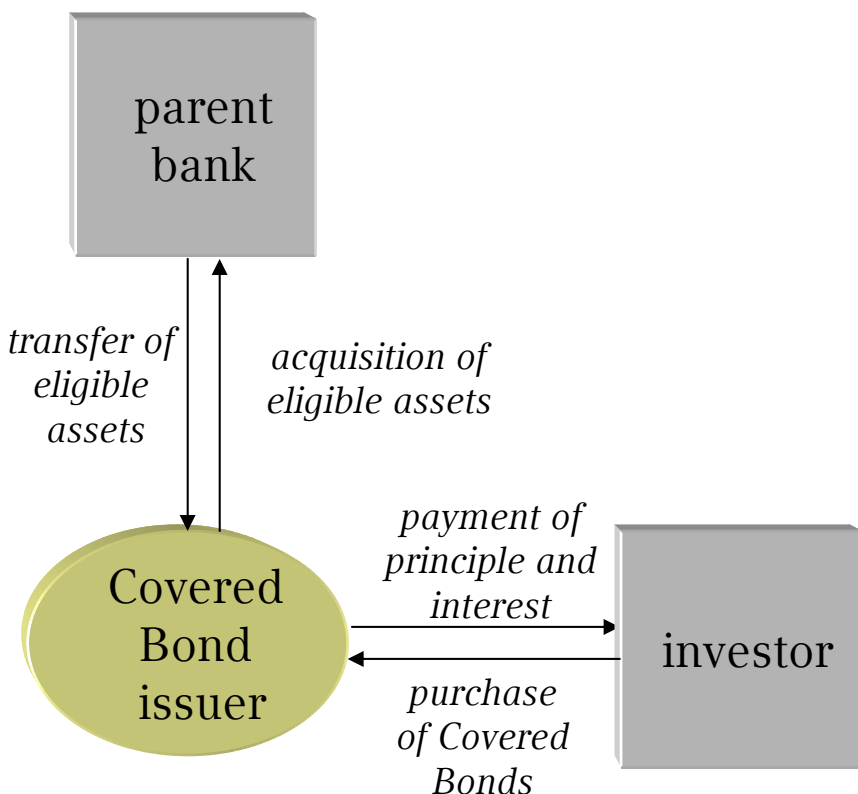
- Pfandbriefe vs. Covered Bonds

### Models of Covered Bonds



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**Covered Bond issuer as completely specialised funding institute:  
Finland, France, Ireland, Norway, partially Sweden, Portugal**



- Origination and servicing of eligible assets and management of covered bond issuing institute by parent bank
- Funding institute has no other function than holding eligible assets
- Issuer has bank status
- Issuance governed by special legal framework
- Issuer has no or nearly no staff



#### 4. Covered Bonds in Europe – legal structures

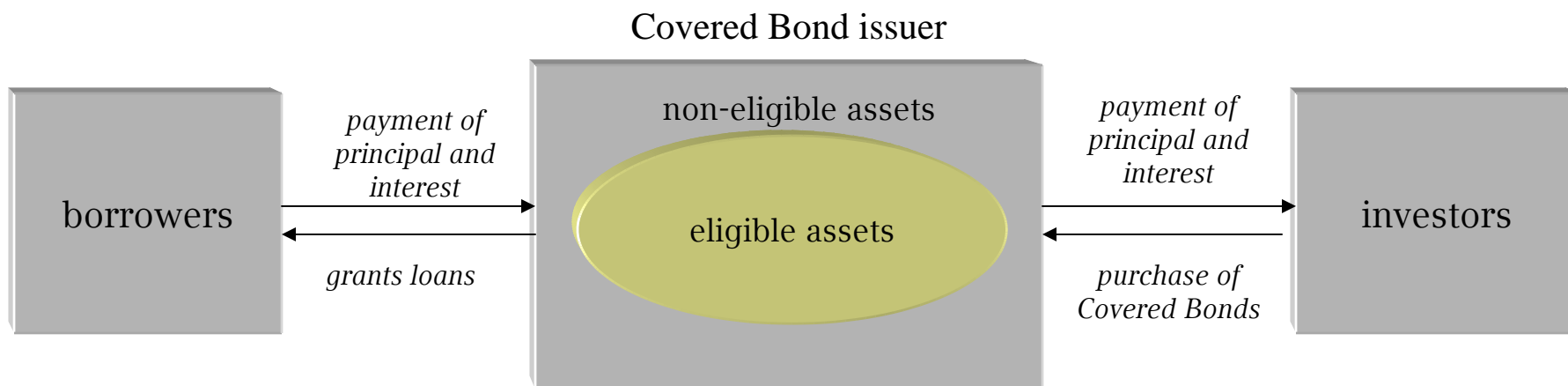
- Pfandbriefe vs. Covered Bonds

### Models of Covered Bonds



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**Covered Bond issuer is specialized bank by law:  
Hungary, Luxemburg, Poland, partially Denmark and Sweden**



- Issuer originates, services and funds eligible business
- Loan origination restricted by law to property and public-sector loans
- Issuer has bank status
- Issuance governed by special legal framework



#### 4. Covered Bonds in Europe – legal structures

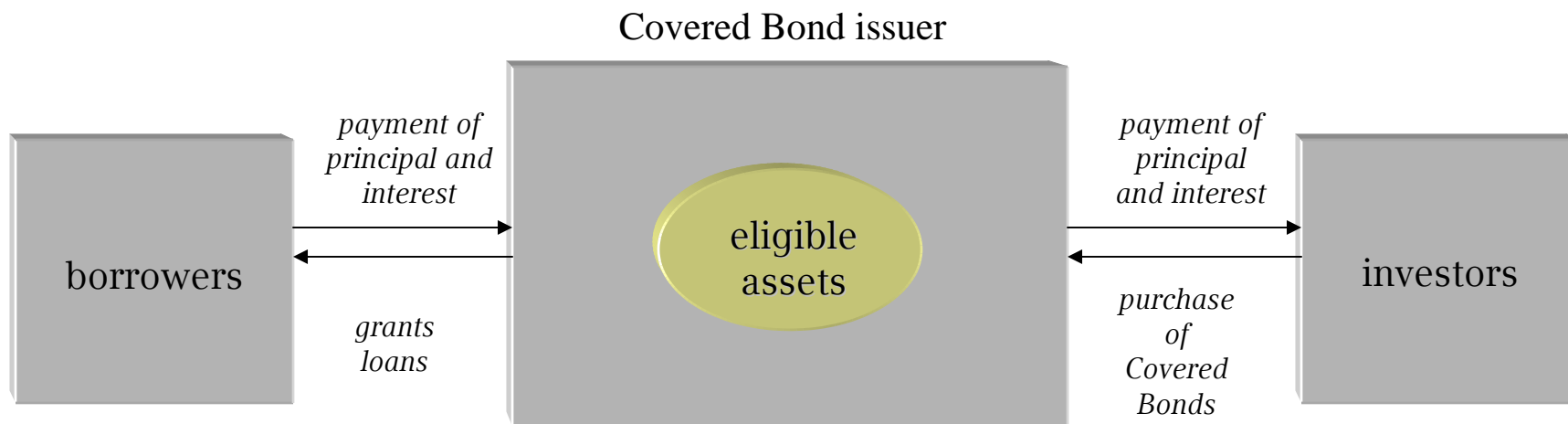
- Pfandbriefe vs. Covered Bonds

### Models of Covered Bonds



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**Covered Bond issuer is universal bank with qualified Covered Bond license:  
Germany, Latvia, Slovenia and partially Denmark**



- Issuer originates, services and funds eligible and non-eligible business
- license granted only to banks complying with legal license requirements
- Strict eligibility criteria apply to eligible cover assets
- Issuance governed by special legal framework



#### 4. Covered Bonds in Europe – legal structures

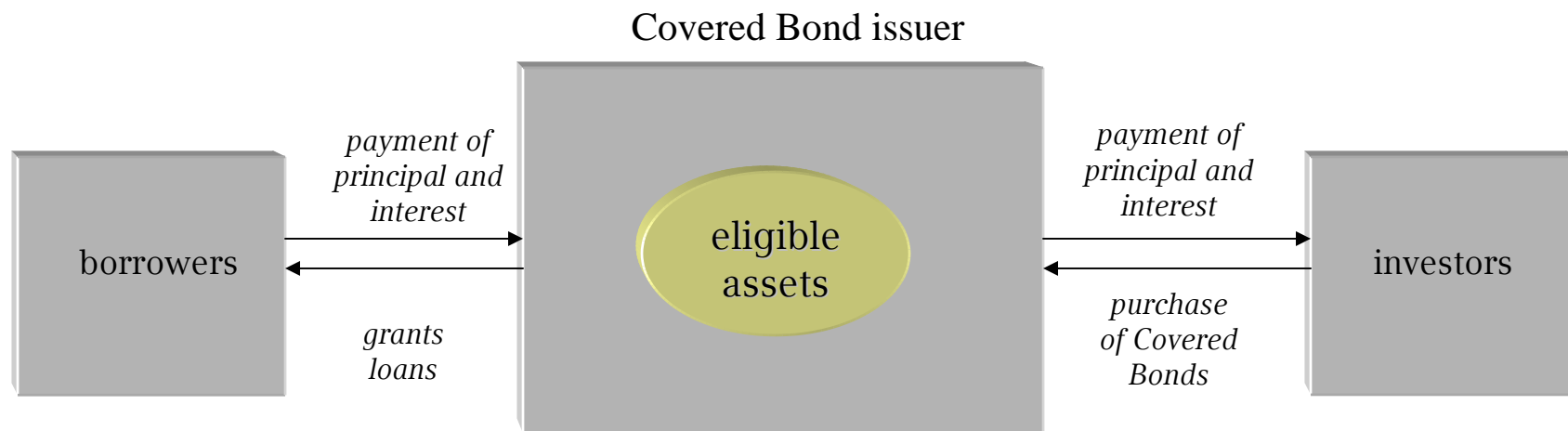
- Pfandbriefe vs. Covered Bonds

##### Models of Covered Bonds



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**Covered Bond issuer as universal bank without qualified license:  
Bulgaria, Czech Republic, Lithuania, Spain, Slovakia and partially Portugal**



- Issuer originates, services and funds eligible and non-eligible business
- Strict eligibility criteria apply to eligible cover assets
- Issuance governed by special legal framework
- No issuing license required or license granted without any requirements



#### 4. Covered Bonds in Europe – legal structures

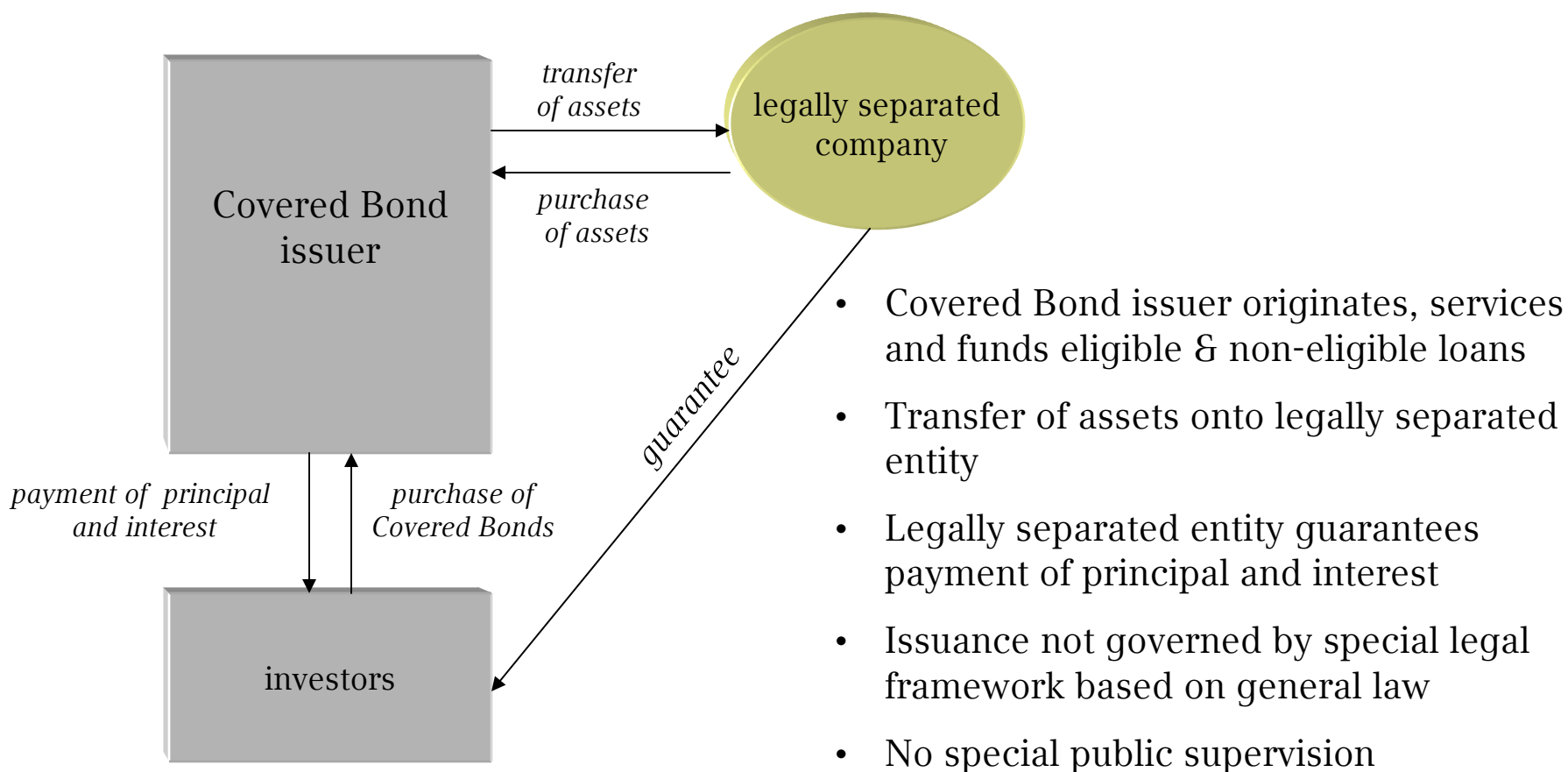
- Pfandbriefe vs. Covered Bonds

### Models of Covered Bonds



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### Covered Bond issuer without special legal framework: Netherlands and partially France



- Covered Bond issuer originates, services and funds eligible & non-eligible loans
- Transfer of assets onto legally separated entity
- Legally separated entity guarantees payment of principal and interest
- Issuance not governed by special legal framework based on general law
- No special public supervision



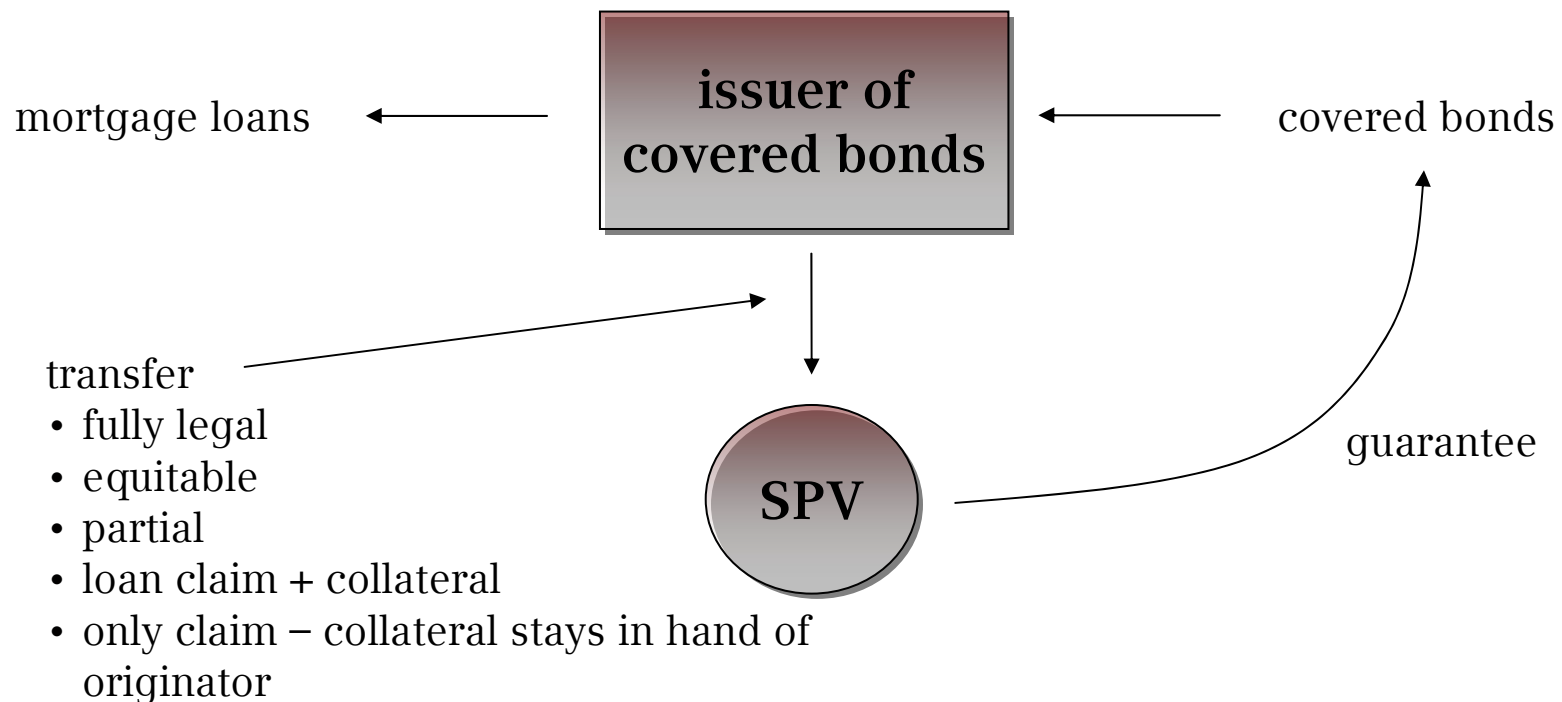
## 4. Covered Bonds in Europe – legal structures



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### Structured covered bonds

**Contractual:** Netherlands  
**Regulated by specific law:** Italy, UK, Greece



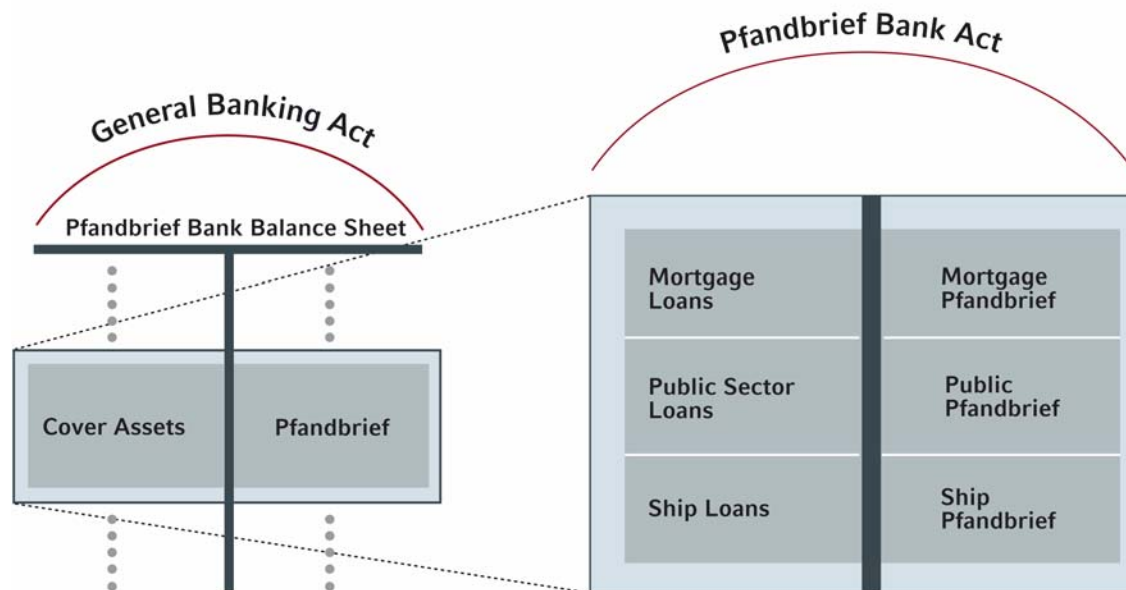
as of 4.4.2008



## 4. Covered Bonds in Europe – legal structures - Pfandbrief fundamentals -



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- Pfandbrief is a bank debenture
- Cover assets remain on balance
- Pfandbrief is collateralized by cover assets subject to strict quality requirements:
  - regional restrictions
  - conservative loan appraisal in property and ship lending
  - only senior loan tranches up to 60% of mortgage lending value eligible for cover
  - loans to public sector subject to public guarantee
- Upon deterioration of cover asset quality: credit check and potential revision or substitution



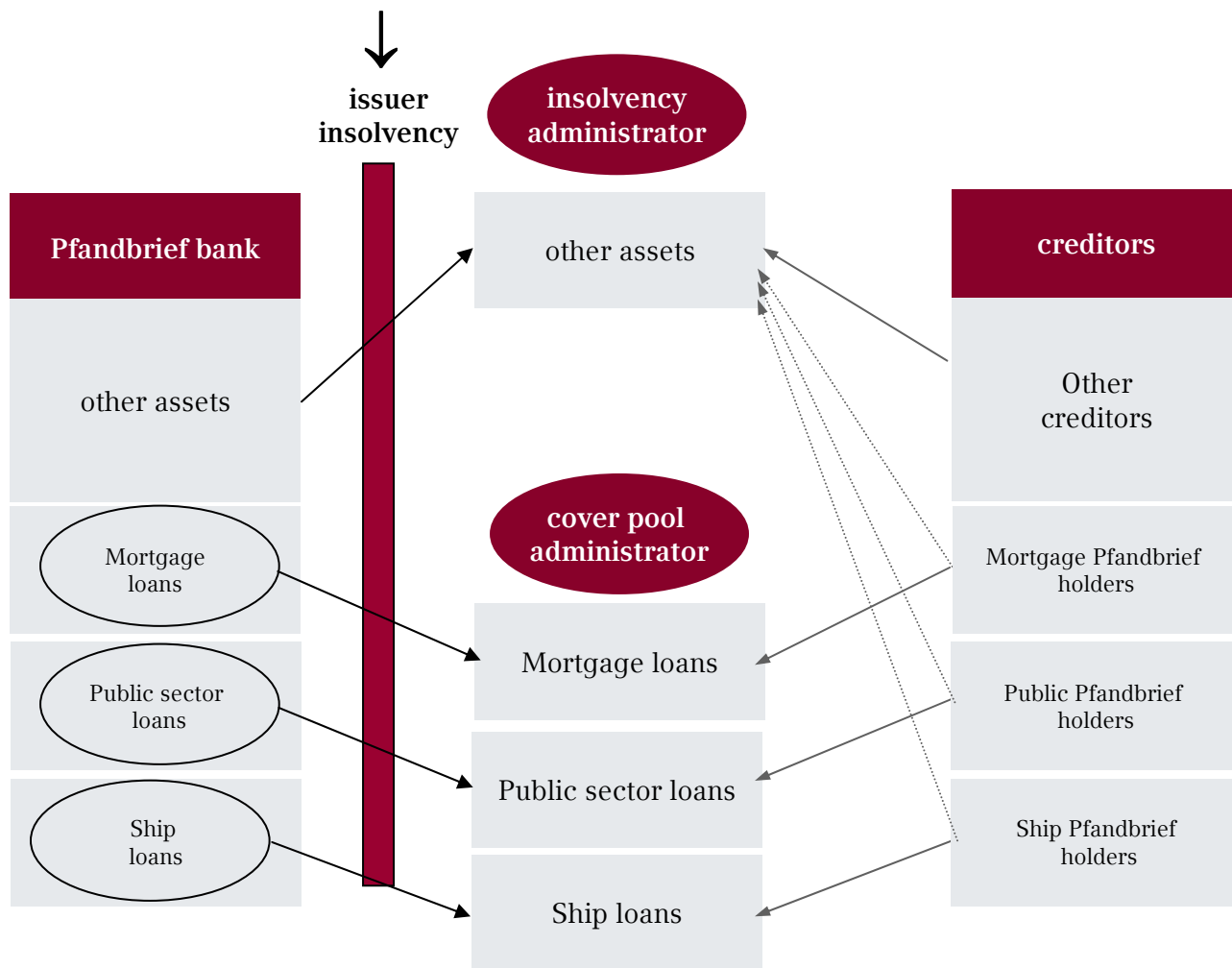
## 4. Covered Bonds in Europe – legal structures - Pfandbrief fundamentals -



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### Insolvency remoteness of Pfandbrief

- No acceleration of Pfandbrief
- Segregation of cover pools
- Insolvency privilege of Pfandbrief holders





## 4. Covered Bonds in Europe – legal structures - Pfandbrief fundamentals -



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**Pfandbrief  
Act  
protects  
Pfandbrief  
holders**

### German Pfandbrief Act

- Special public supervision
  - Pfandbrief license requires sustained issuance and special expertise
  - Ongoing supervision and cover audits by supervisory authority (BaFin)
  - Permanent monitoring of high quality standards of cover assets by cover pool monitor
- Cover principle
  - Cover and mandatory overcollateralization of outstanding Pfandbrief on net present value basis
  - Strict stress testing scenarios
- Transparency
  - Regular disclosure of key data related to Pfandbrief outstanding and cover assets
- Insolvency remoteness of Pfandbrief
  - Segregation of cover pools and Pfandbrief outstanding from the insolvent estate
- Detailed emergency plan in crisis of issuer
  - Appointment of cover pool administrator by court



#### 4. Covered Bonds in Europe – legal structures

- Pfandbriefe vs. Covered Bonds

#### Insolvency segregation of cover pools



Fundamental question: what does „covered“ mean?

purpose = transformation of cover assets into covered bonds (securitisation)

cover assets

≥

covered bonds



- quality of assets
- management of
  - interest rate risks
  - liquidity risks
  - operational risks

designation of cover assets to holders of covered bonds



- **segregation** of cover assets from originator's other assets in case of insolvency of originator
- **bankruptcy remoteness** of cover assets and covered bonds



timeliness of payment realistic?



The less covered bond issuers are **legally specialised**, the more and detailed regulations their covered bonds need in order to achieve clear segregation and bankruptcy remoteness and to convince capital markets of it.



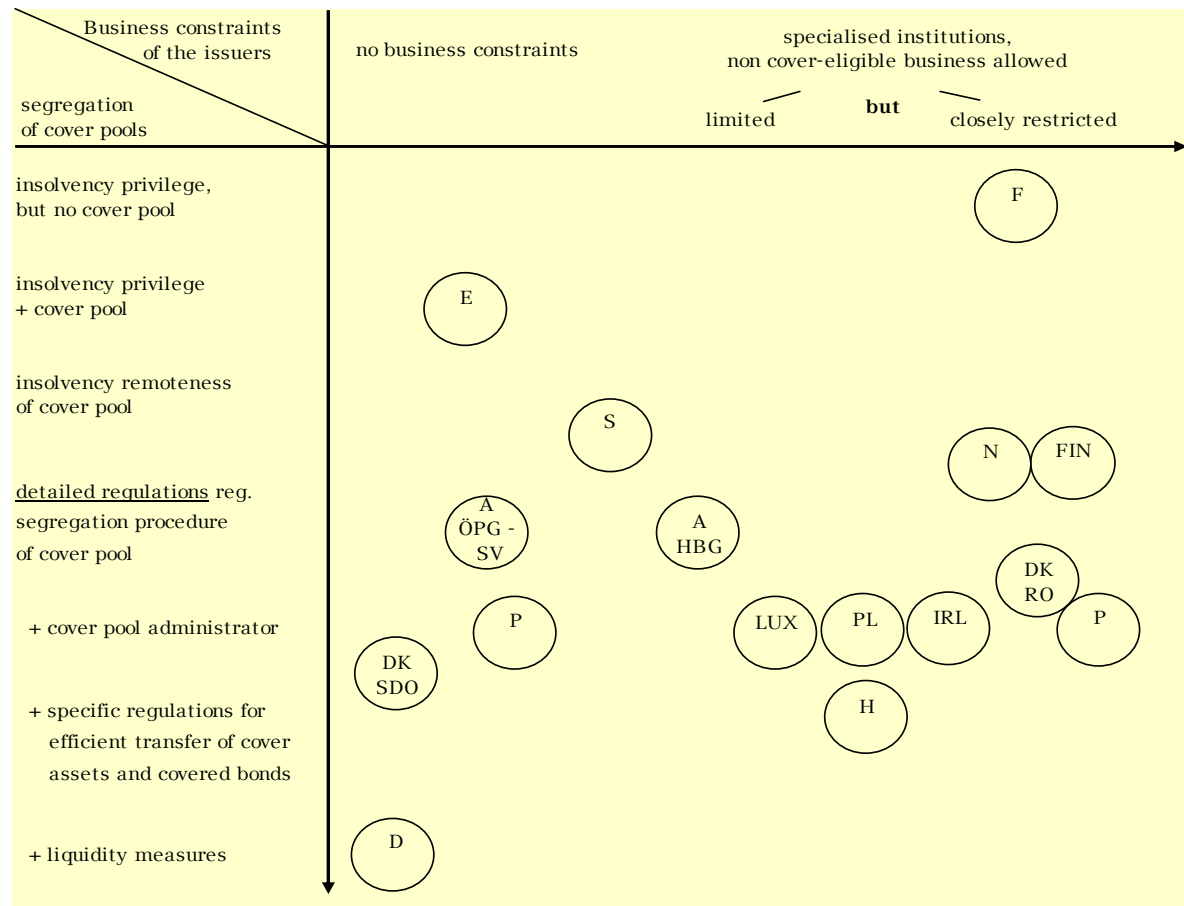
## 4. Covered Bonds in Europe – legal structures

- Pfandbriefe vs. Covered Bonds
- Insolvency segregation of cover pools



The less specialised the issuer, the more details required in legislation!

**DRAFT !**



as of 5.2.2008



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## 5. EU law on Covered Bonds



## 5. EU law on Covered Bonds UCITS Directive



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### Criteria of Art. 22 IV (UCITS Directive)

- Article 22(4) of this Directive defines the minimum requirements that provide the basis for privileged treatment of so-called “certain bonds” in different areas of European financial market regulation.
- Article 22(4) allows a special treatment,
  - ✓ when these “certain” bonds are issued by a **credit institution** which has its registered office in a Member State
  - ✓ and is subject by **law** to special public **supervision** designed to protect bondholders.
  - ✓ Sums deriving from the issue of these bonds must be invested in conformity with the **law** in **assets** which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds,
  - ✓ which, in the event of **failure** of the issuer, would be used on a **priority** basis for the reimbursement of the principal and payment of the accrued interest.



## 5. EU law on Covered Bonds CRD



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Covered bonds  
benefit from  
privileged credit risk  
weightings only if  
they fulfil the  
following  
requirements:

1. Compliance with the standards of Article 22(4) of Directive 85/611/EEC (UCITS)
2. The asset pools that back the covered bonds must be constituted only of assets of specifically-defined types and credit quality
3. New quantitative restrictions on certain types of cover assets were established (e.g. max 15% exposure to credit institutions).
4. The issuers of covered bonds backed by mortgage loans must meet certain minimum requirements regarding mortgage property valuation and monitoring



## 5. EU law on Covered Bonds CRD



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### Eligibility of cover assets according to CRD

- exposures to public sector entities (0% or 20% risk weighted)
- exposures to banks (limited to 15%)
- loans secured by residential (up to 80% LTV) and commercial (up to 60 % LTV) real estate subject to strict valuation standards
- AAA-MBS tranches if 90 % of the loans comply with LTV's mentioned above
- loans secured by ships up to 60 % LTV



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## 6. ECBC – essential features on Covered Bonds



## 6. ECBC – essentials features on Covered Bonds



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ECBC

Steering Committee

Covered bonds are characterised by the following common essential features that are achieved under both special-law frameworks and general-law based frameworks:

- The bond is issued by – or bondholders otherwise have full recourse to – a credit institution which is subject to public supervision and regulation.
- Bondholders have a claim against a cover pool of financial assets in priority to unsecured creditors of the credit institution.
- The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.
- The obligations of the credit institution in respect of the cover pool are supervised by public or other independent bodies.



## 7. ECBC – comparative table



## 7. ECBC Comparative Table



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### ECBC Comparative Table (as at 29.02.2008):

- I. Structure of the Issuer
- II. Framework
- III. Cover assets
- IV. Valuation of the Mortgage C  
over Pool & LTV Criteria
- V. Asset-Liability Guidelines
- VI. Cover Pool Monitor and Banking Supervision
- VII. Segregation of Assets and Bankruptcy Remoteness
- VIII. Risk Weighting and Compliance with European Legislation

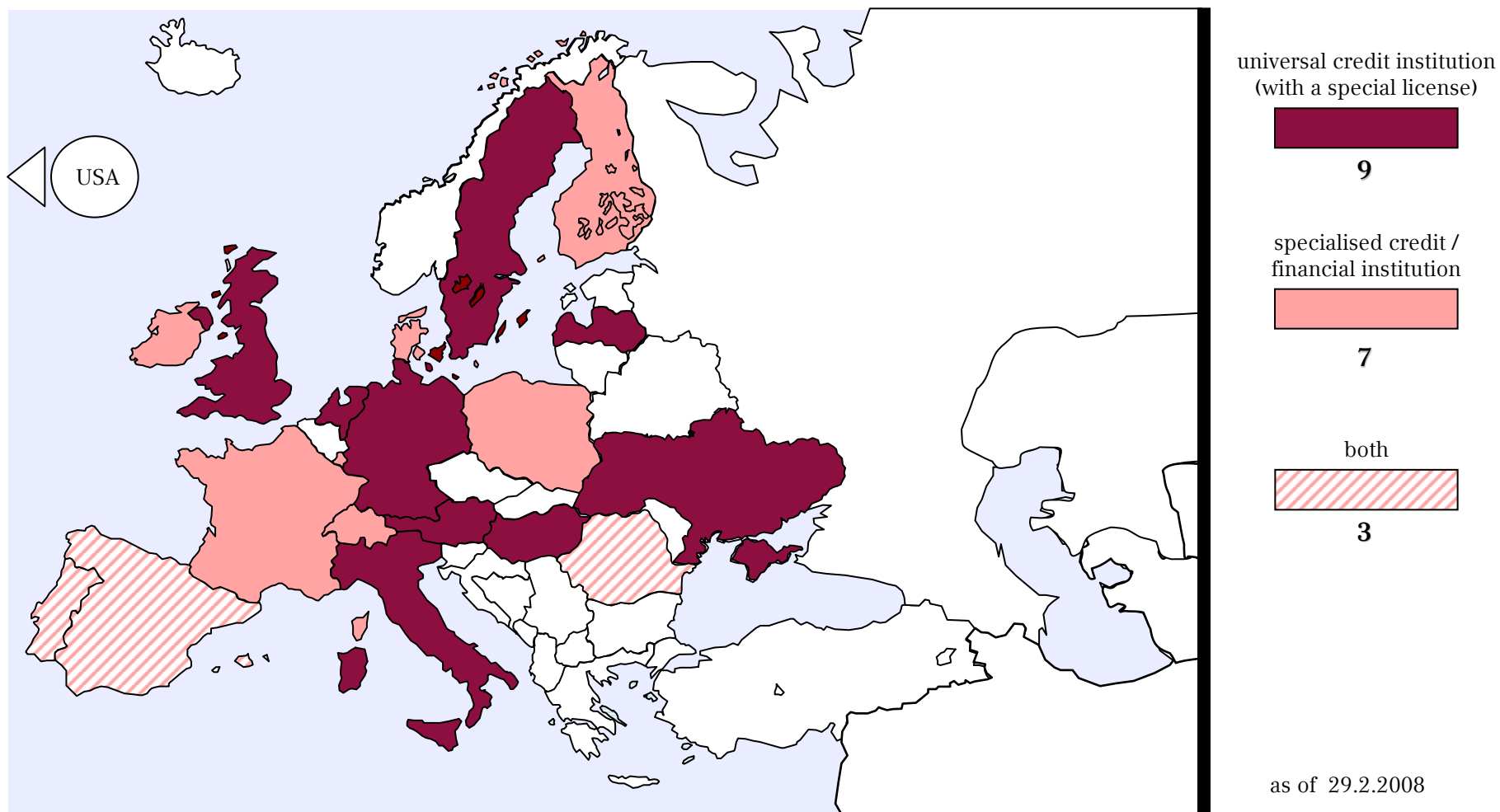


## 7. ECBC Comparative table I. Structure of the Issuer



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### I.1: Who is the issuer?



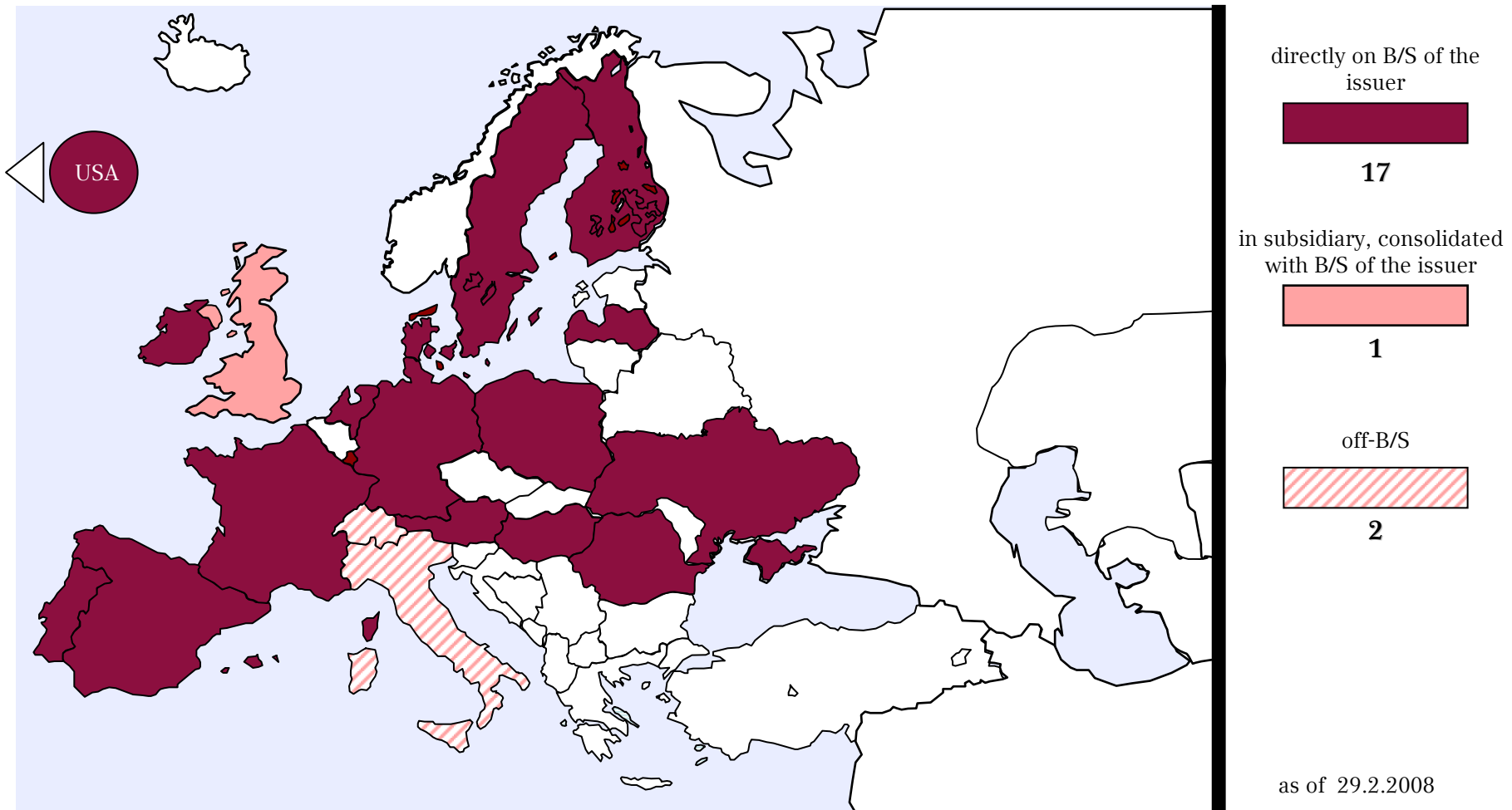


## 7. ECBC Comparative table I. Structure of the Issuer



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### I.2: Where are the cover assets located? (accounting treatment)



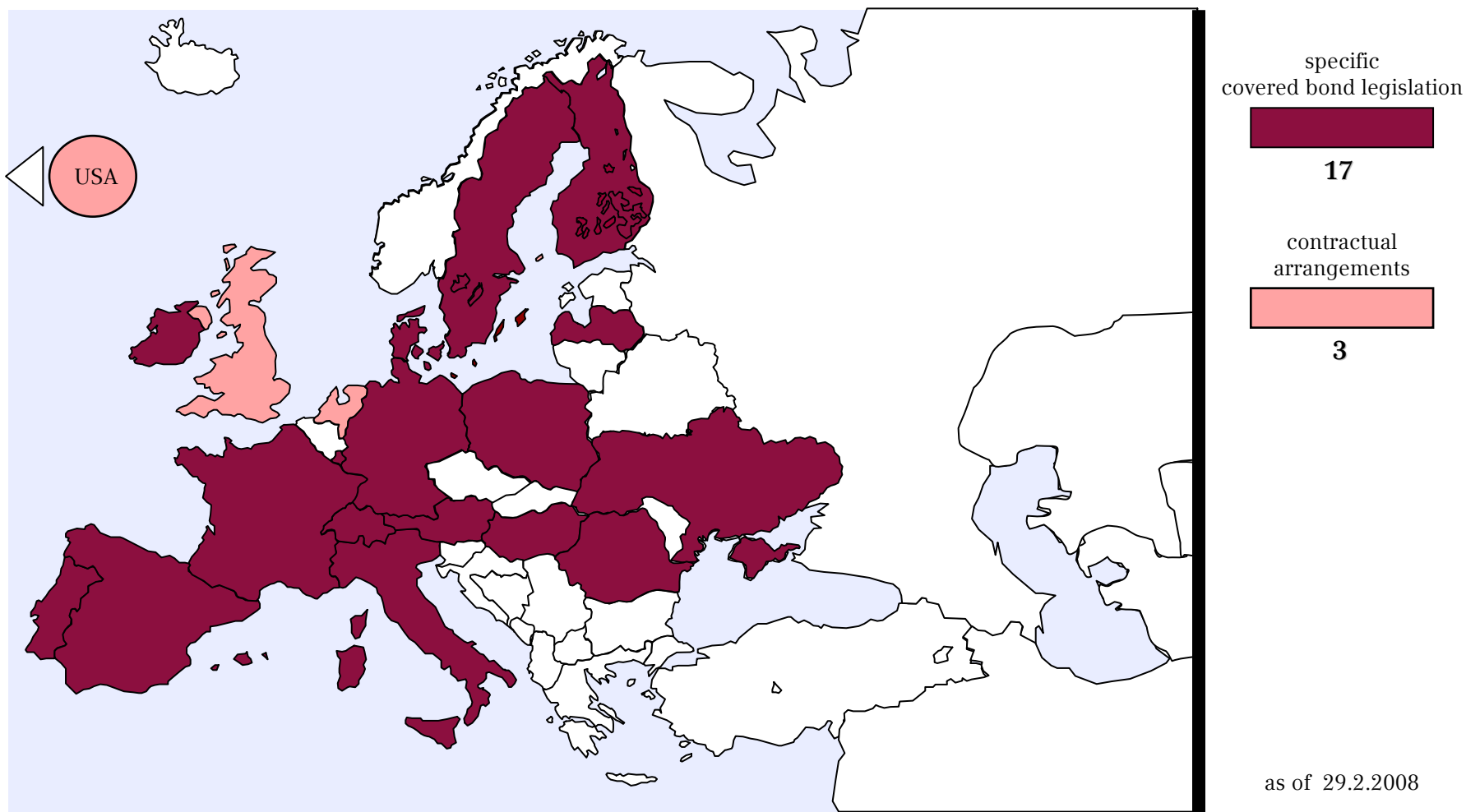


## 7. ECBC Comparative table II. Framework



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### II.1: What governs covered bond issuance?



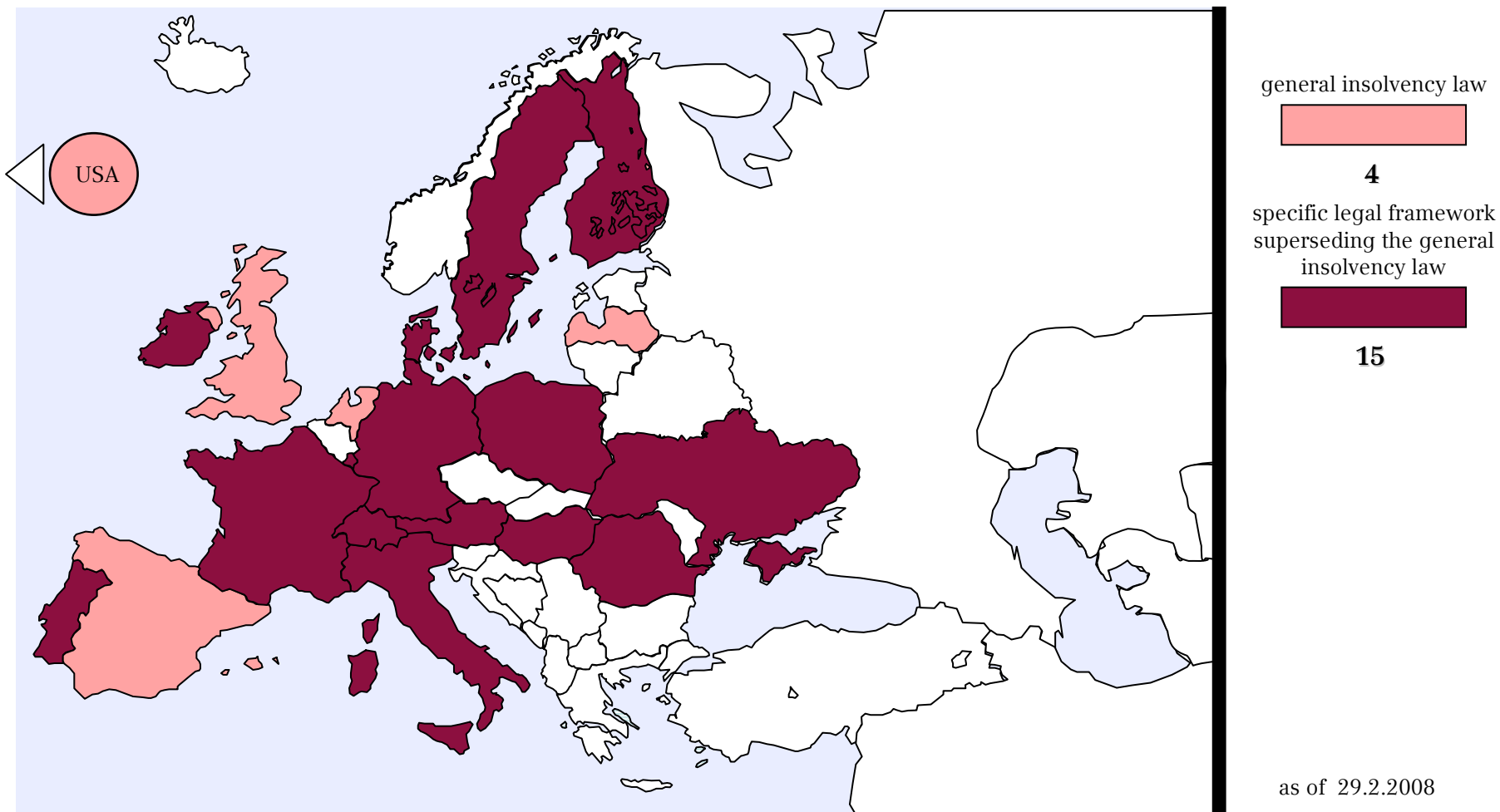


## 7. ECBC Comparative table II. Framework



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II.2: What is the legal framework for bankruptcy of the issuer for covered bonds?





## 7. ECBC Comparative table III. Cover Assets



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III.1: What types of assets may be included in the cover pool?



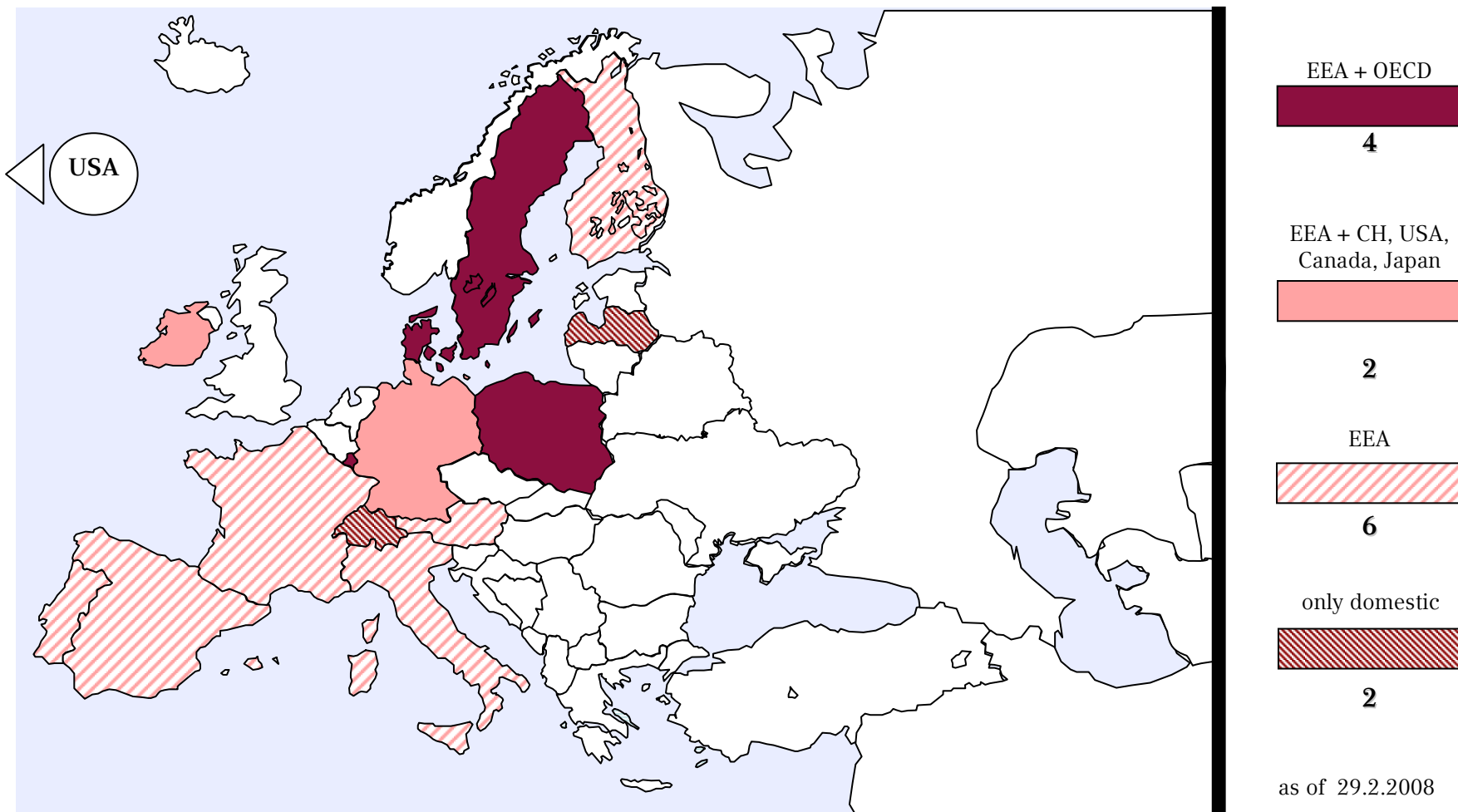


## 7. ECBC Comparative table III. Cover Assets



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### III.2: What is the geographical scope for public sector assets?



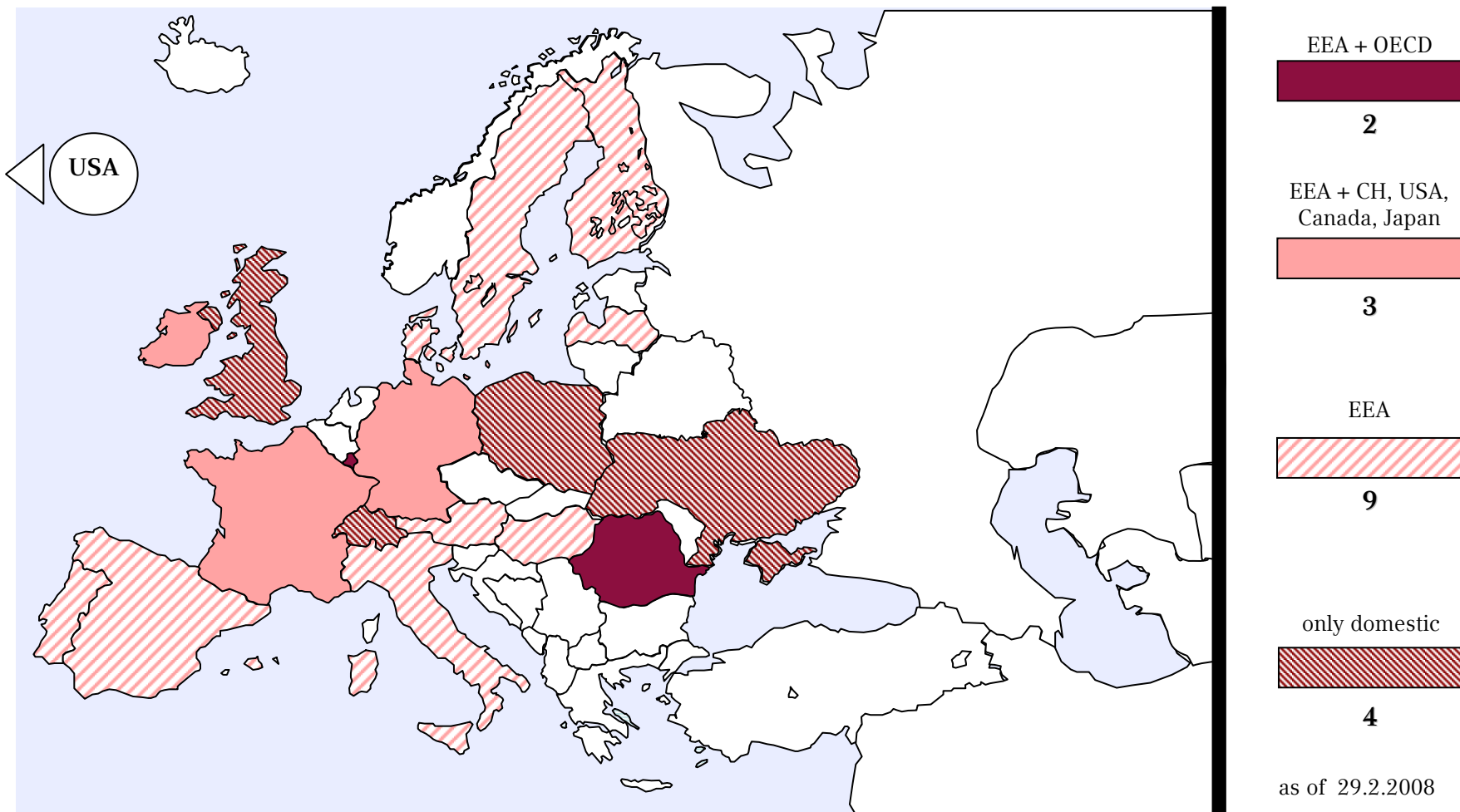


## 7. ECBC Comparative table III. Cover Assets



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### III.3: What is the geographical scope for mortgage assets?



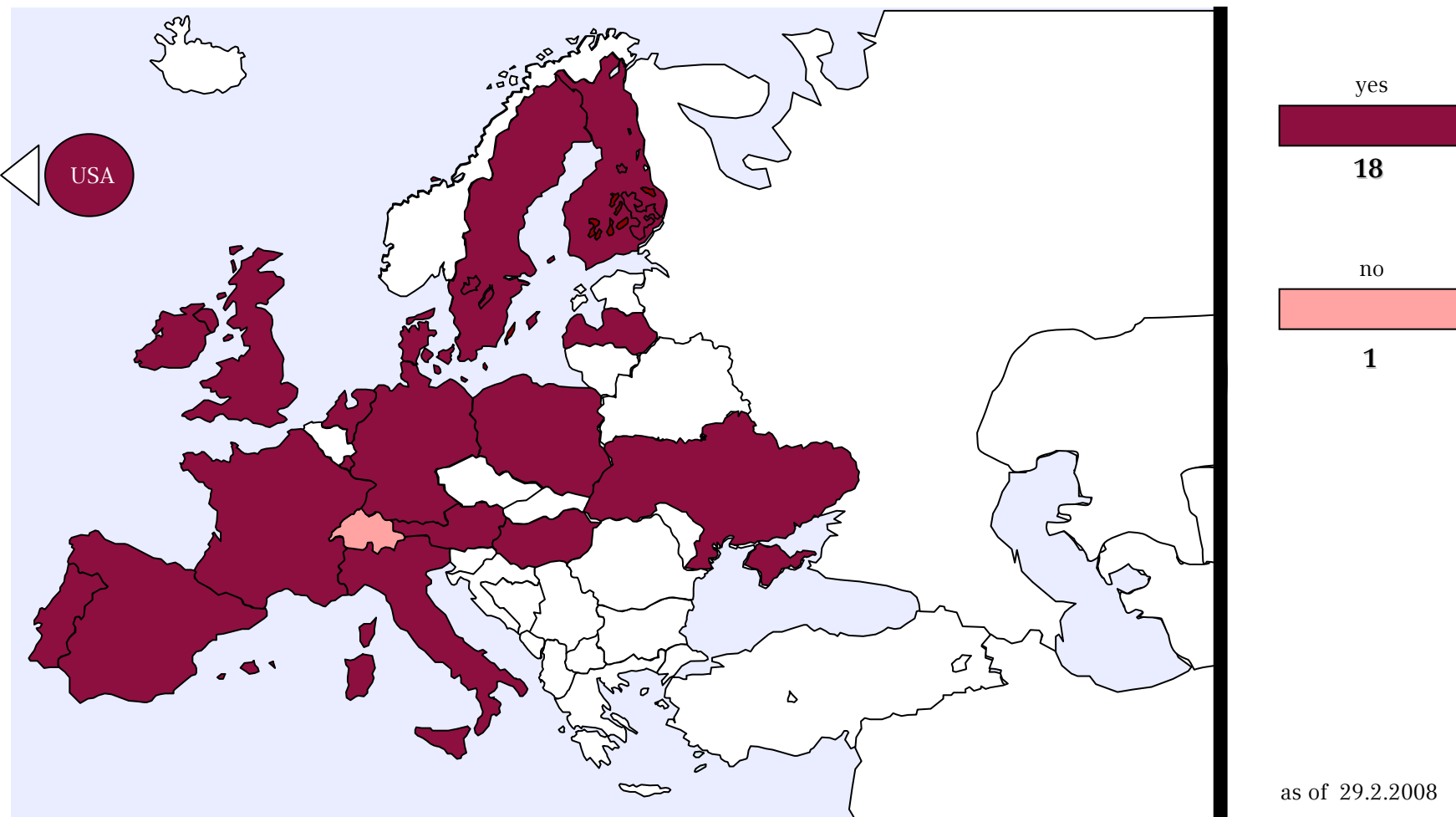


## 7. ECBC Comparative table III. Cover Assets



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### III.4: Is the use of derivatives permitted in the cover pool?



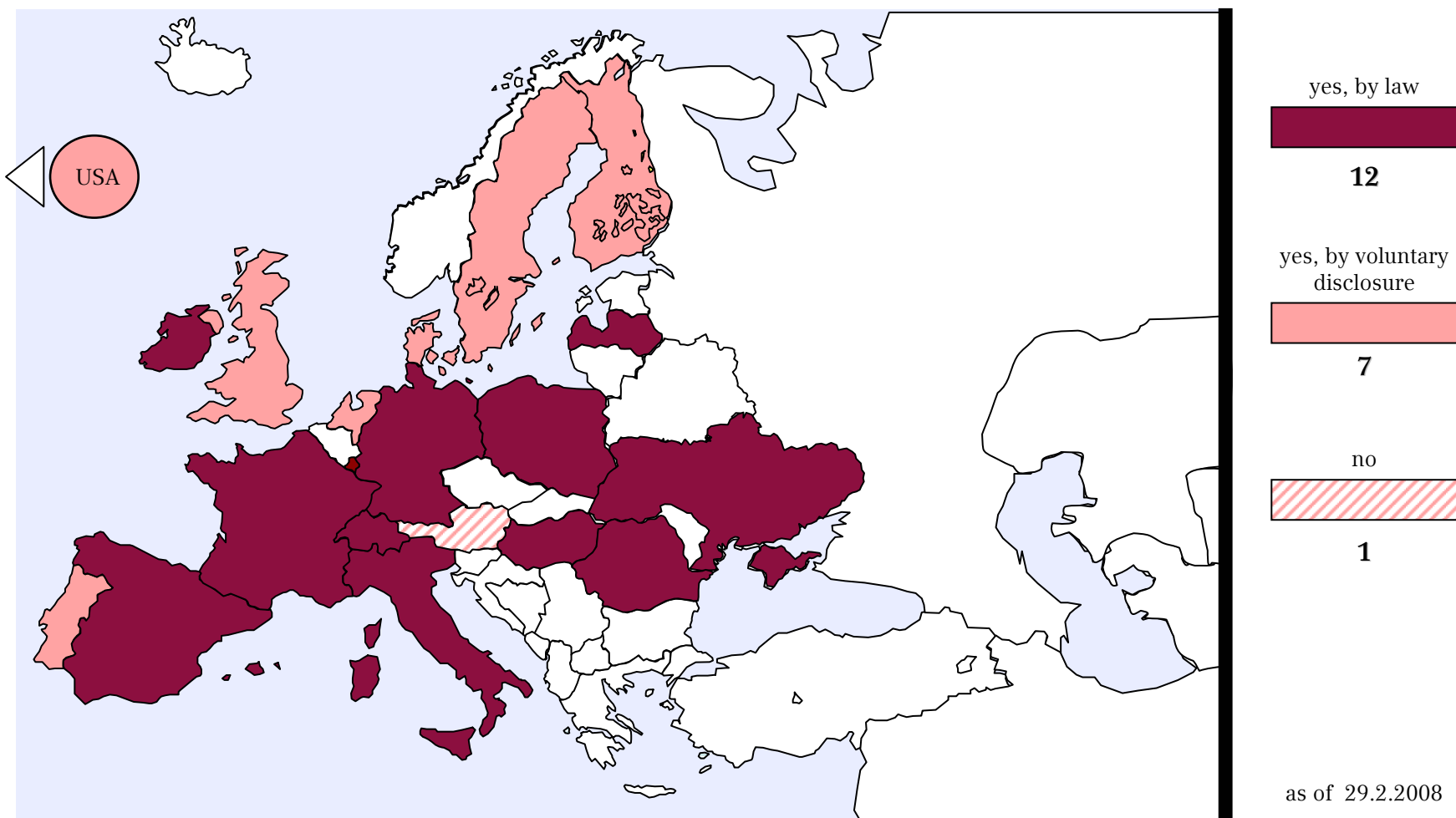


## 7. ECBC Comparative table III. Cover Assets



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III.5: Are there regular covered bond specific disclosure requirements to the public?



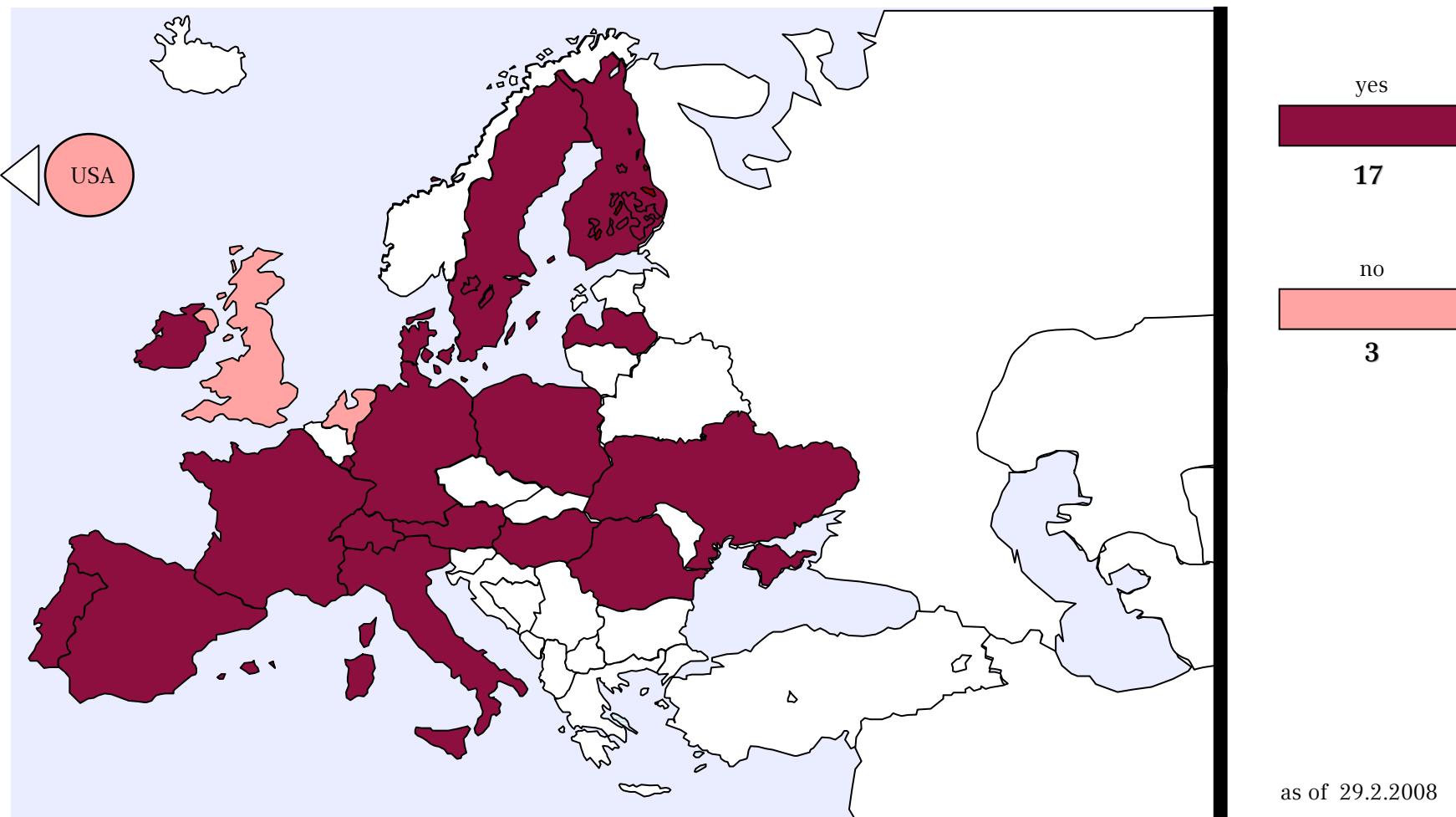


## 7. ECBC Comparative table IV. Valuation of the mortgage cover pool & LTV criteria



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### IV.1: Are there legal provisions for property valuation?



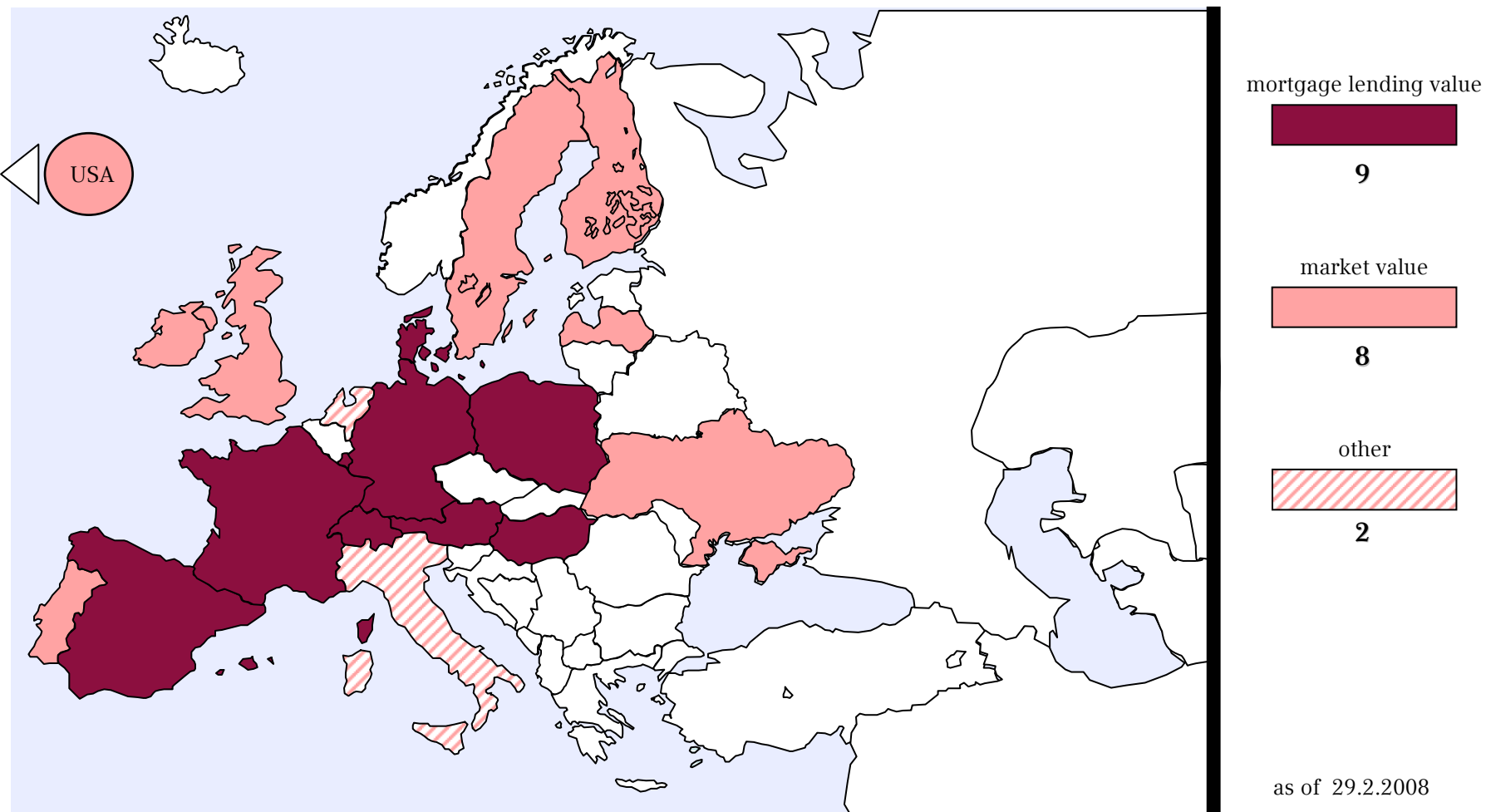


## 7. ECBC Comparative table IV. Valuation of the mortgage cover pool & LTV criteria



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### IV.2: What is the basis for property valuation?





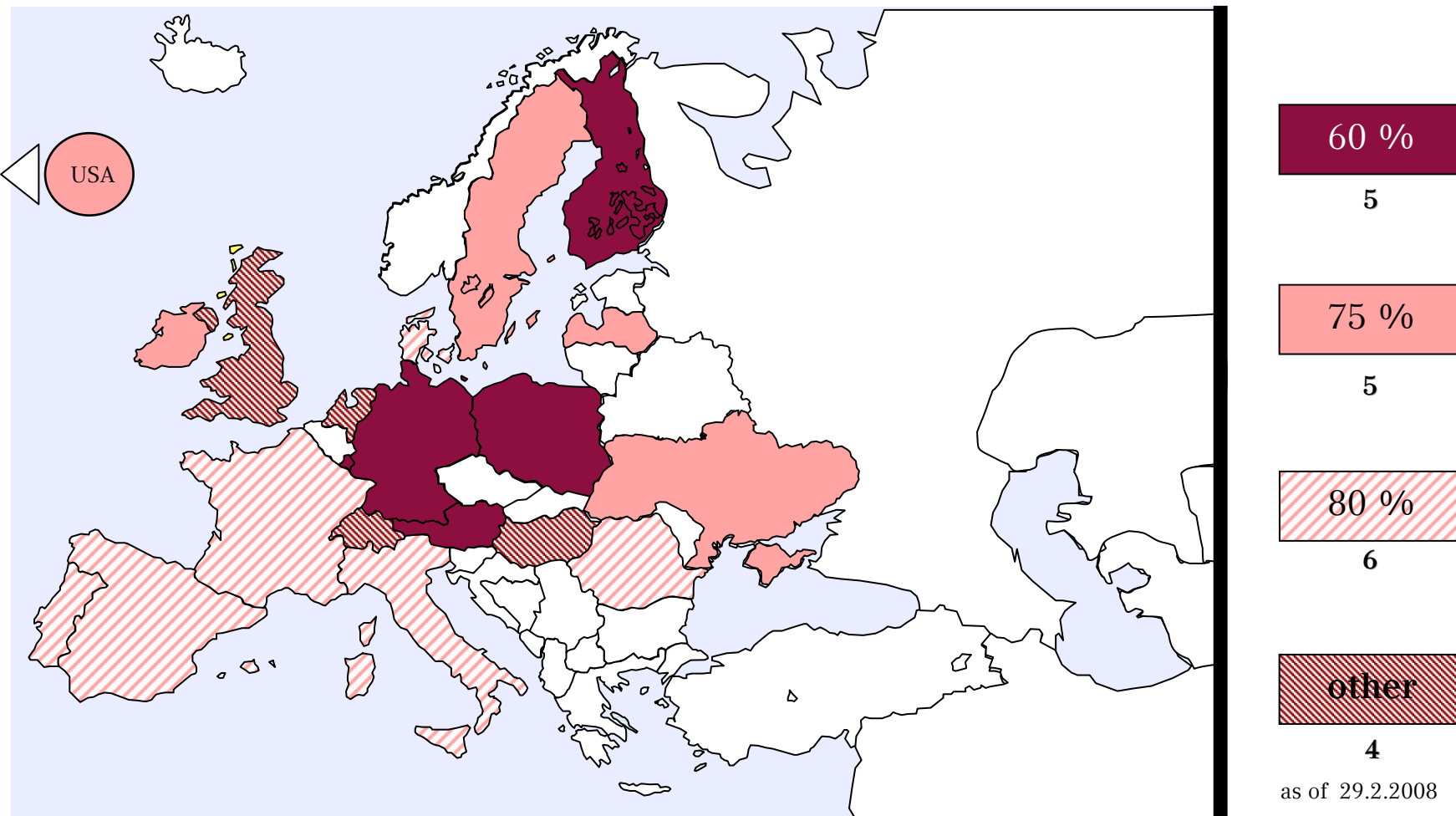
## 7. ECBC Comparative table IV. Valuation of the mortgage cover pool & LTV criteria



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PFANDBRIEFBANKEN**  
Association of German Pfandbrief Banks

IV.3: What are the LTV limits (single asset based)?

**RESIDENTIAL**





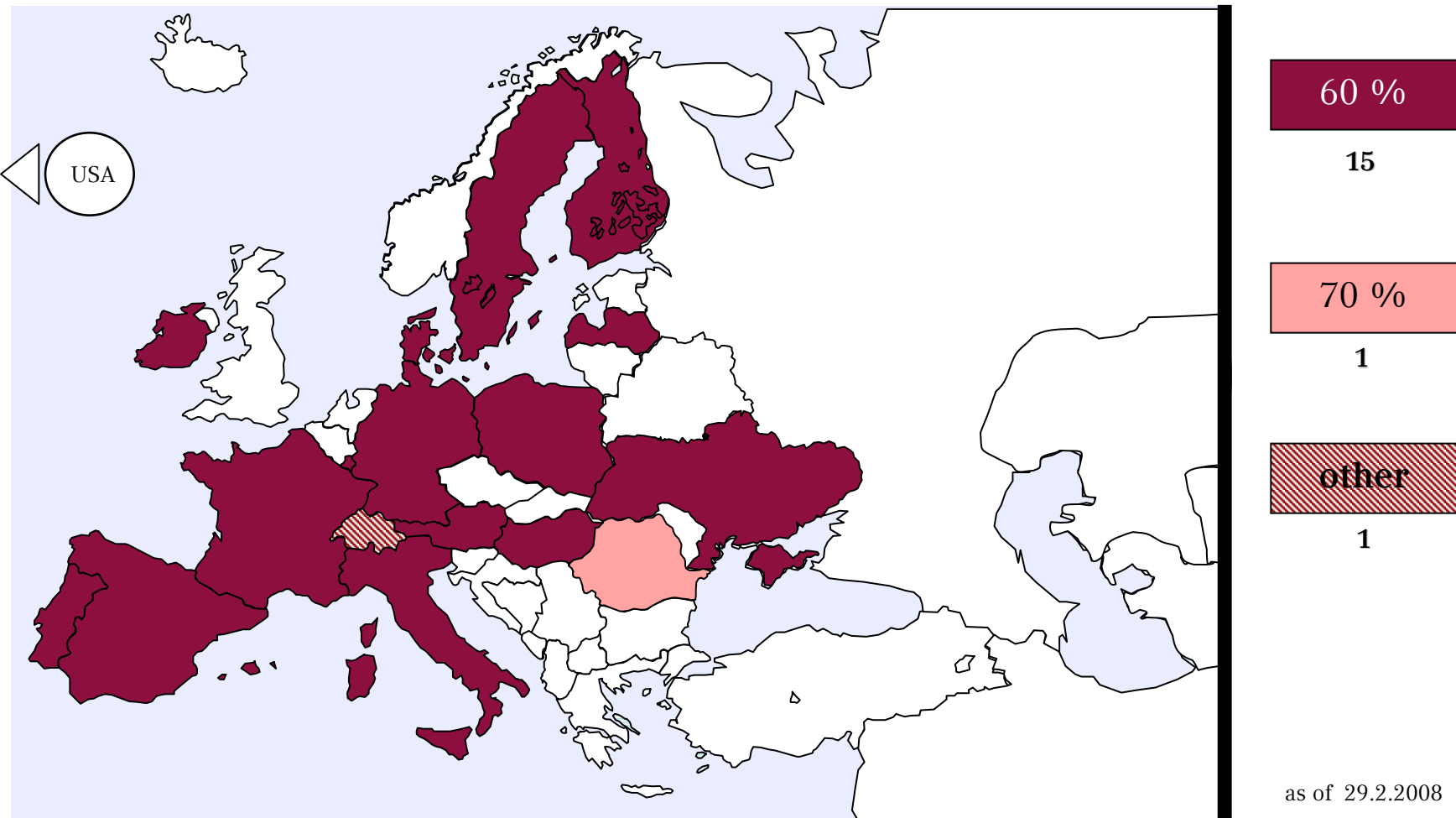
## 7. ECBC Comparative table IV. Valuation of the mortgage cover pool & LTV criteria



**VERBAND DEUTSCHER  
PFANDBRIEFBANKEN**  
Association of German Pfandbrief Banks

### IV.3: What are the LTV limits (single asset based)?

### COMMERCIAL



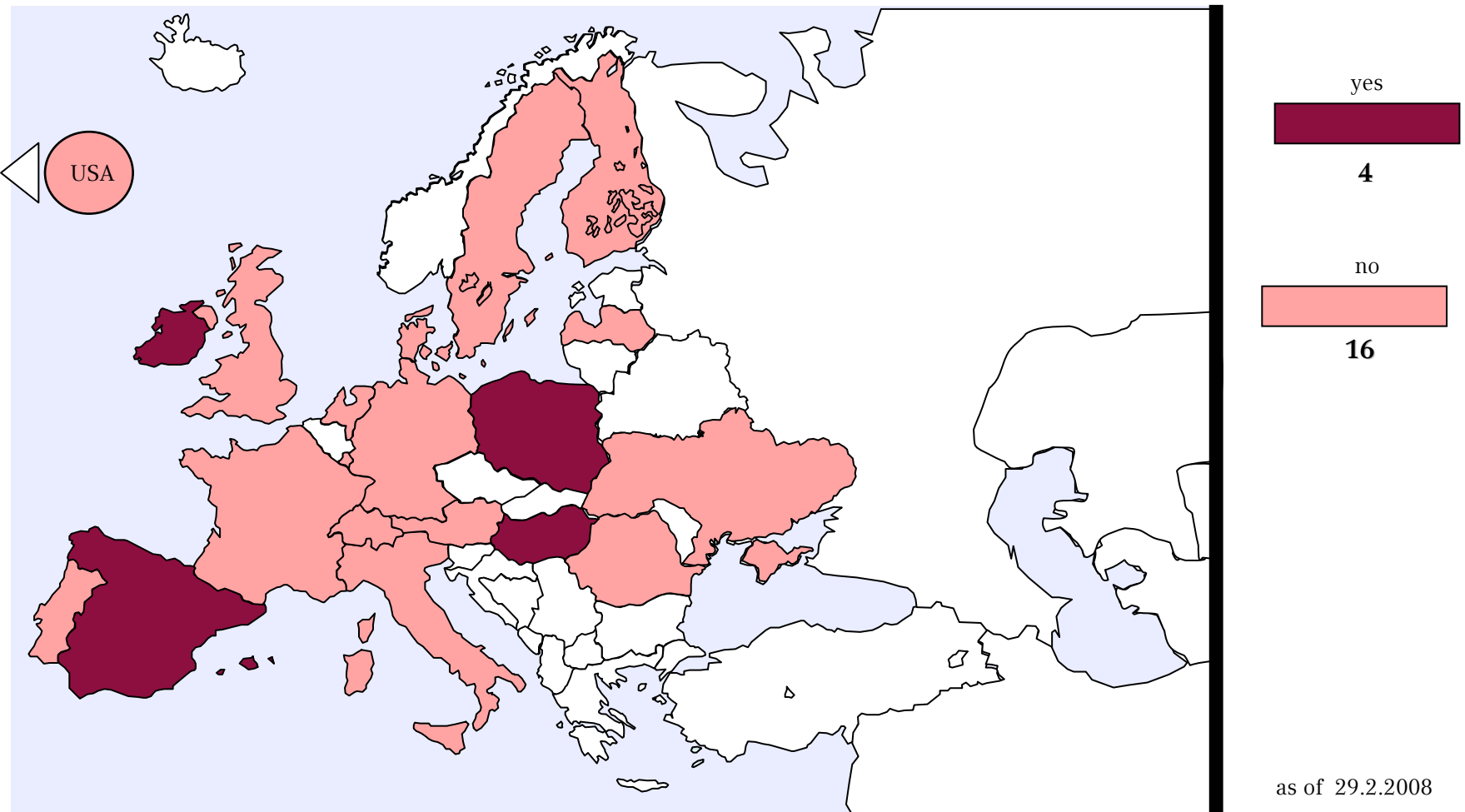


## 7. ECBC Comparative table IV. Valuation of the mortgage cover pool & LTV criteria



**VERBAND DEUTSCHER  
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IV.4: Is there any additional LTV limit on a portfolio basis?



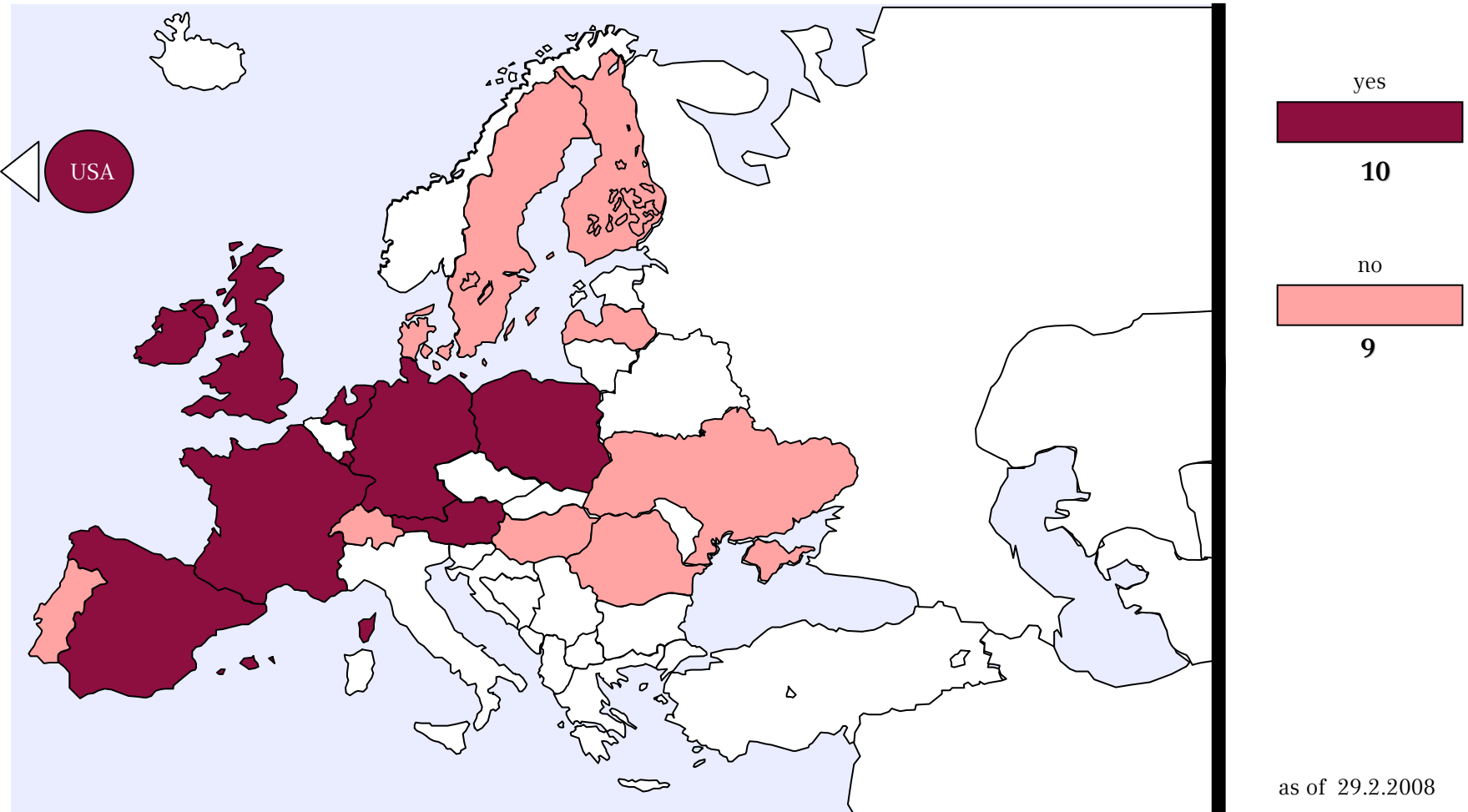


## 7. ECBC Comparative table IV. Valuation of the mortgage cover pool & LTV criteria



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IV.5: Are loans in excess of LTV limits eligible for inclusion in the cover pool?





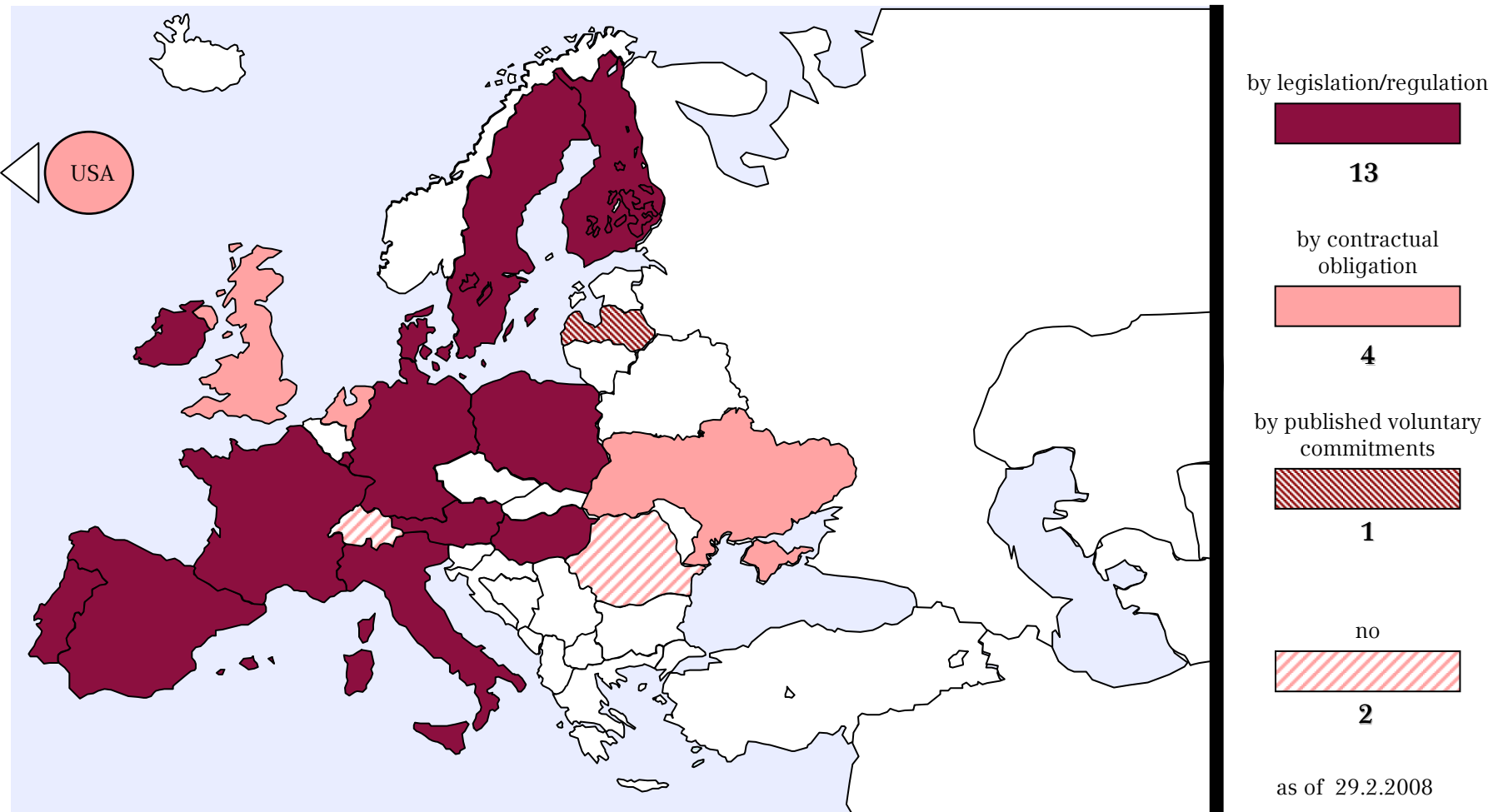
## 7. ECBC Comparative table V. Asset-liability guidelines



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V.1: Are there risk mitigating provisions for

a) interest rate risk(s)?





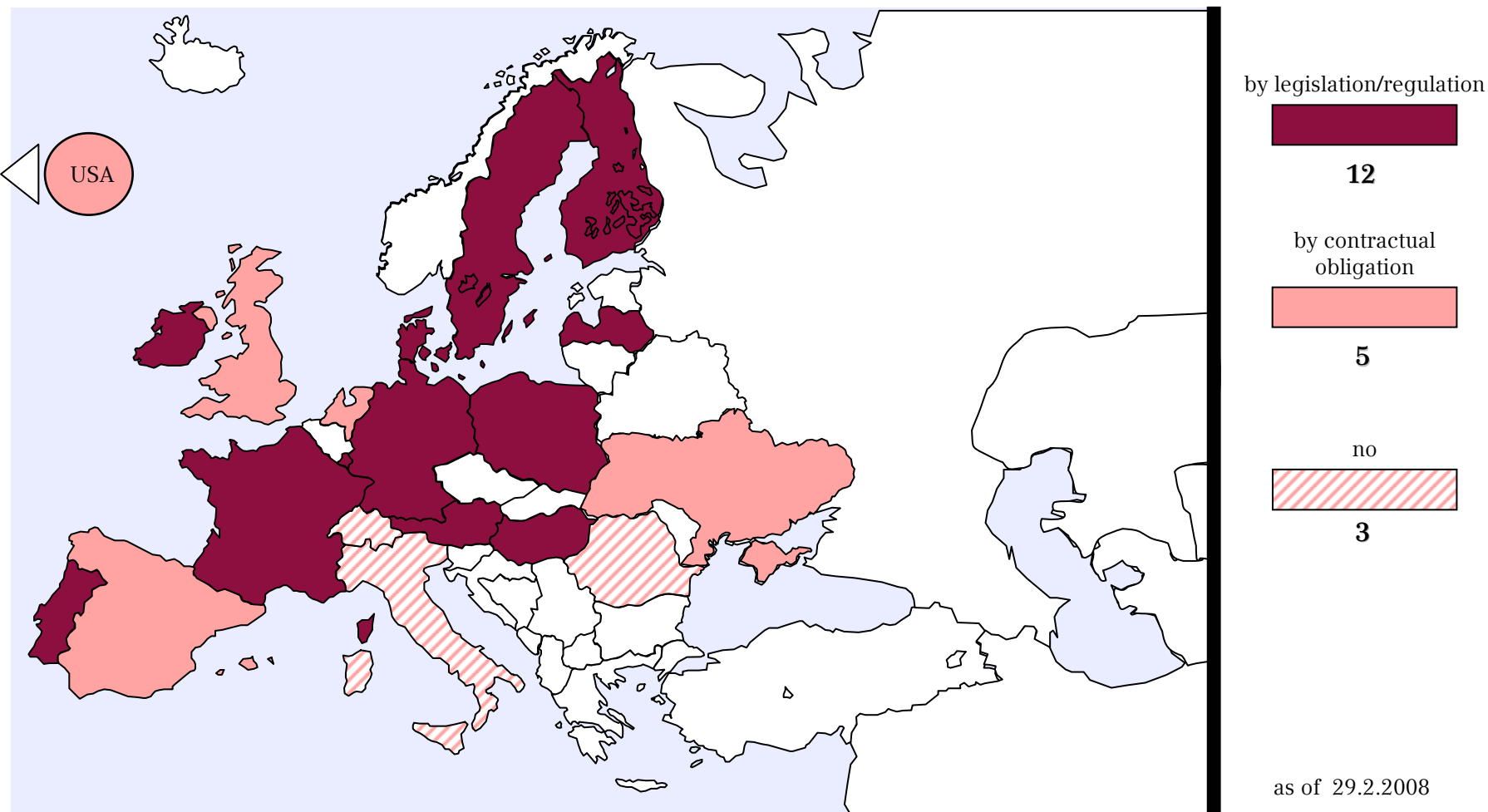
## 7. ECBC Comparative table V. Asset-liability guidelines



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V.1: Are there risk mitigating provisions for

b) foreign exchange risk(s)?





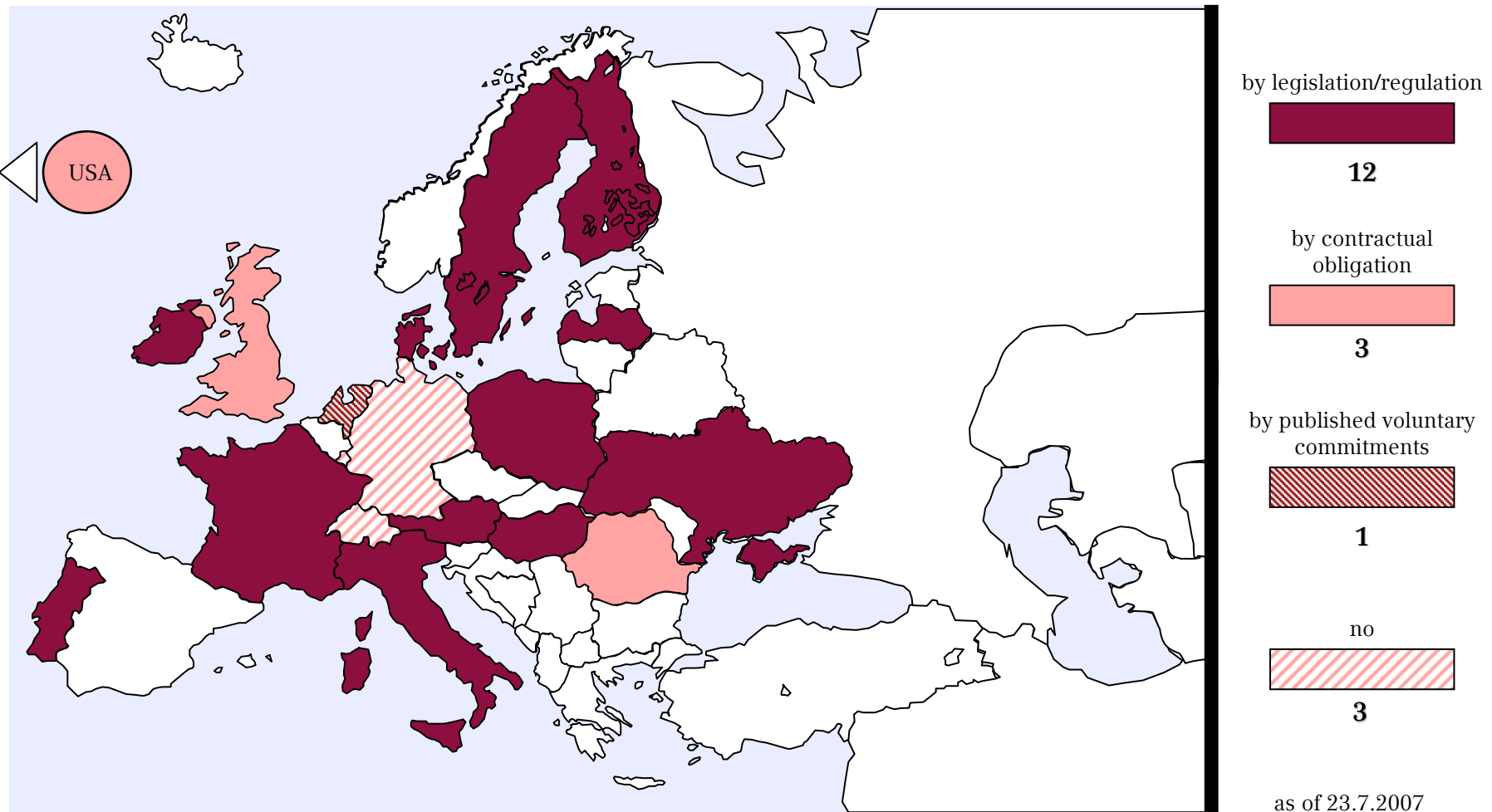
## 7. ECBC Comparative table V. Asset-liability guidelines



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V.1: Are there risk mitigating provisions for

c) maturity mismatch risk(s)?



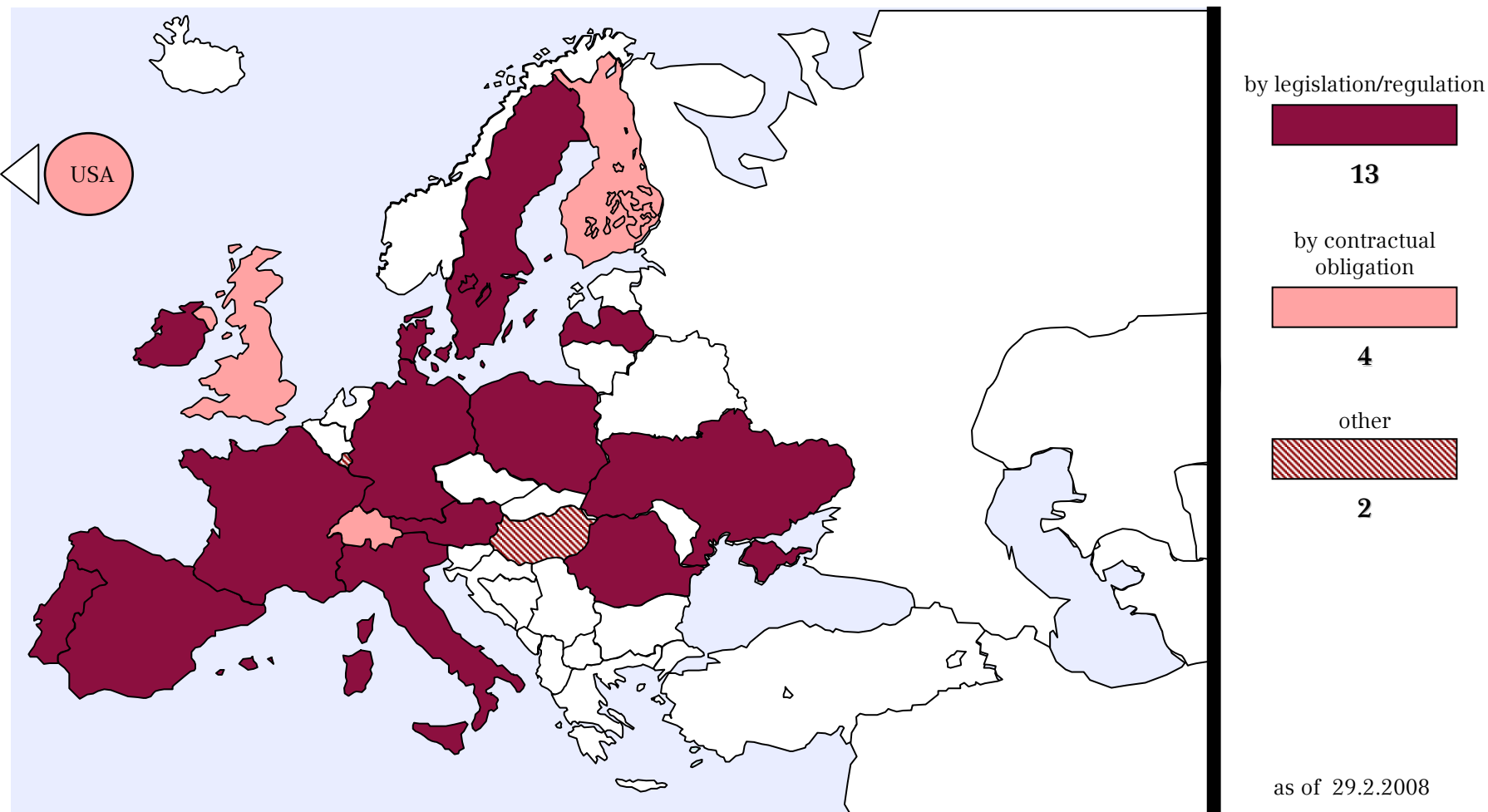


## 7. ECBC Comparative table V. Asset-liability guidelines



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### V.2: Is mandatory overcollateralisation required?



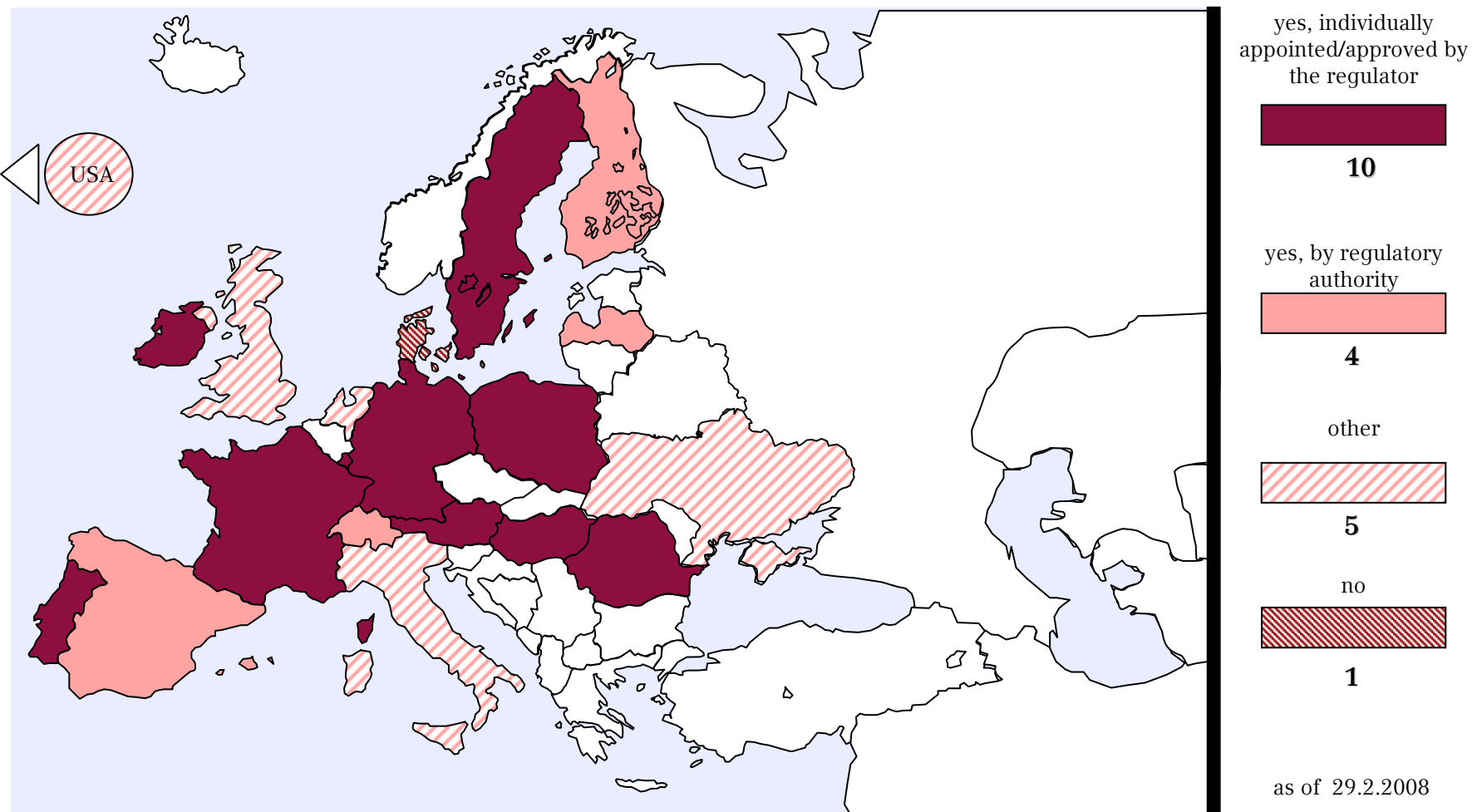


## 7. ECBC Comparative table VI. Cover pool monitor & banking supervision



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### VI.1: Is there a cover pool monitor independent from the issuer?



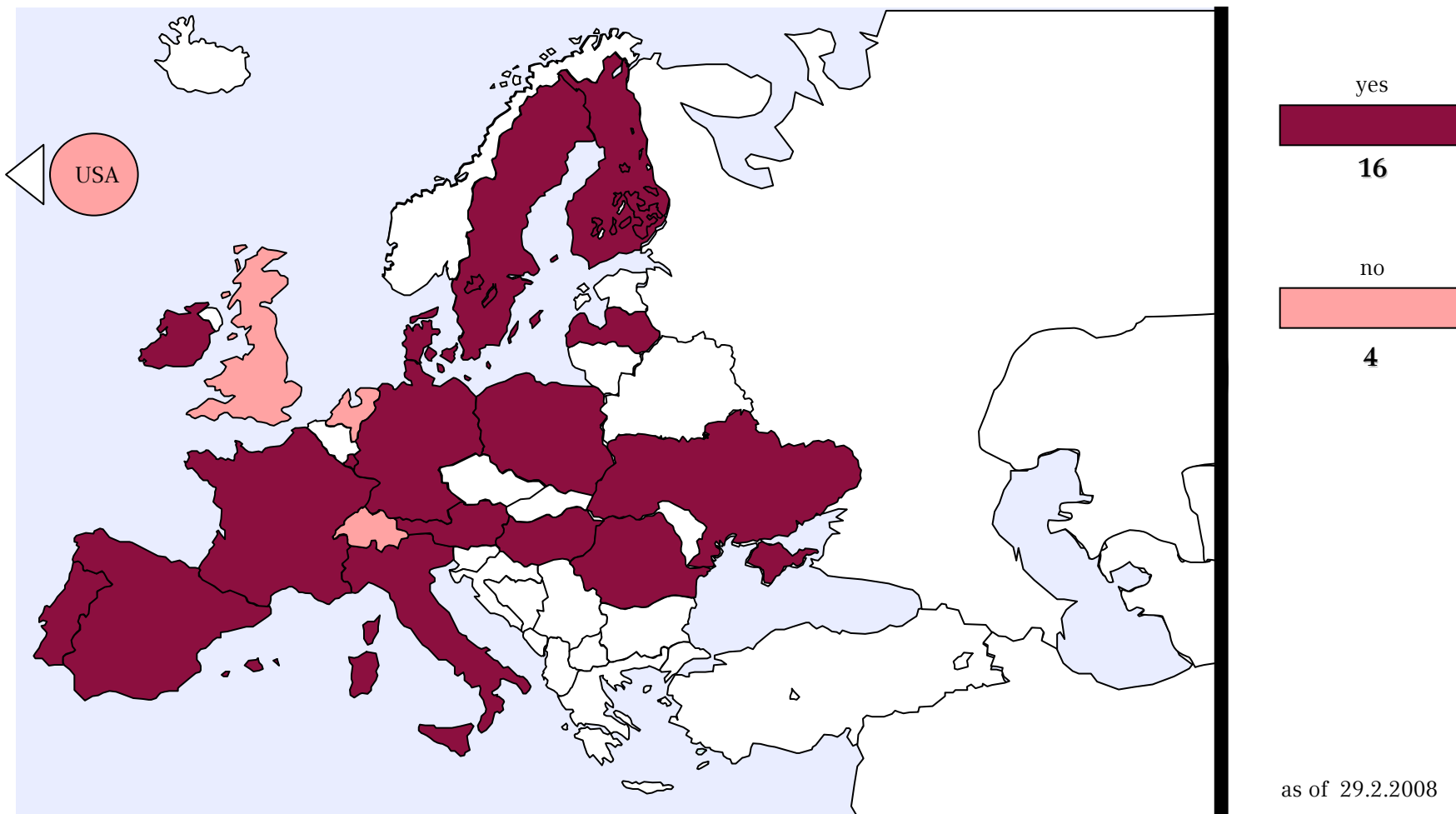


## 7. ECBC Comparative table VI. Cover pool monitor & banking supervision

vdp

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VI.2: Is there a special banking supervision according to UCITS 22(4)?



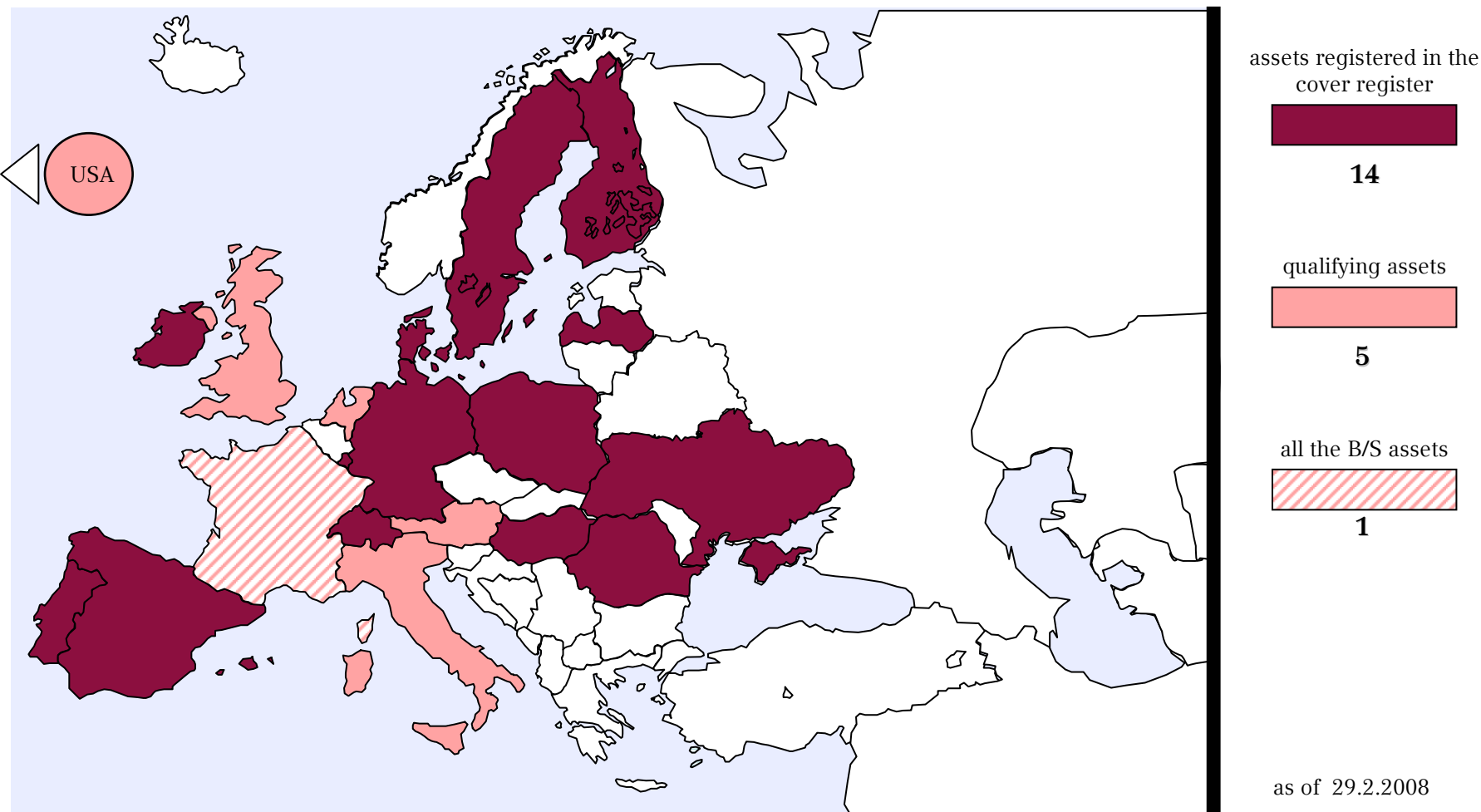


## 7. ECBC Comparative table VII. Segregation of assets & bankruptcy remoteness



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### VII.1: What is the cover pool?



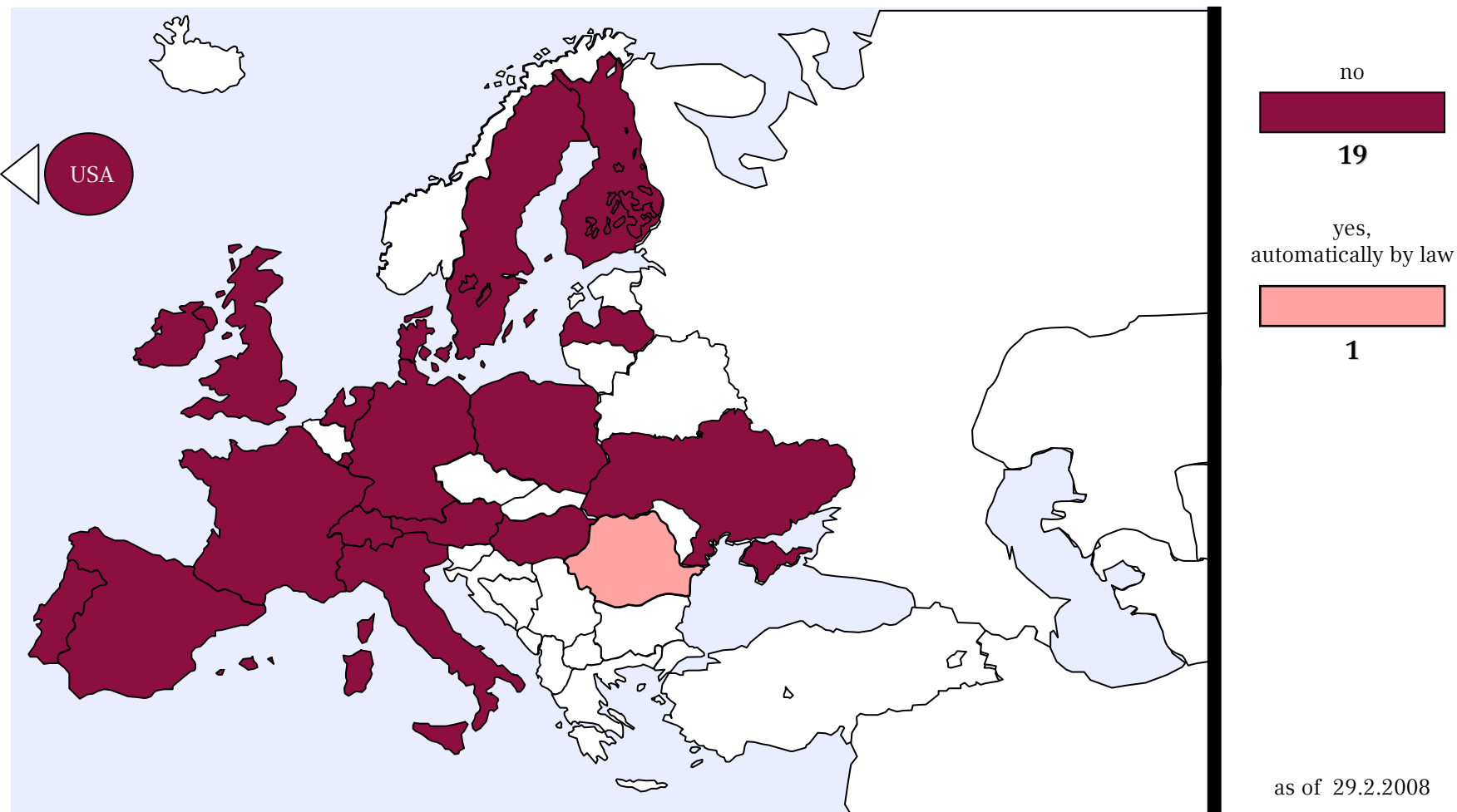


## 7. ECBC Comparative table VII. Segregation of assets & bankruptcy remoteness



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### VII.2: Do covered bonds accelerate, when the issuer goes insolvent?



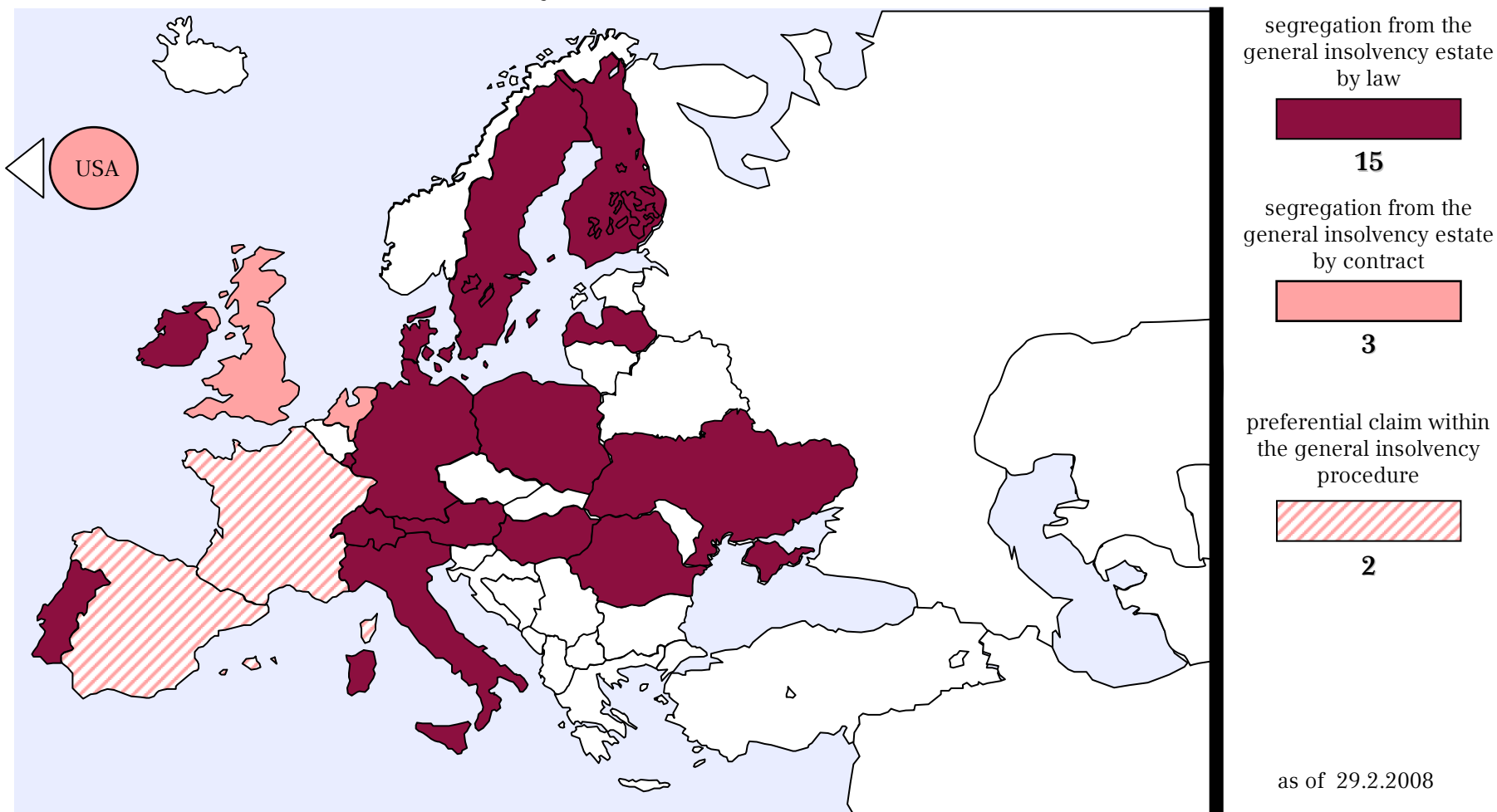


## 7. ECBC Comparative table VII. Segregation of assets & bankruptcy remoteness



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VII.3: How are the covered bond holders protected against claims from the other creditors in case of insolvency of the issuer?



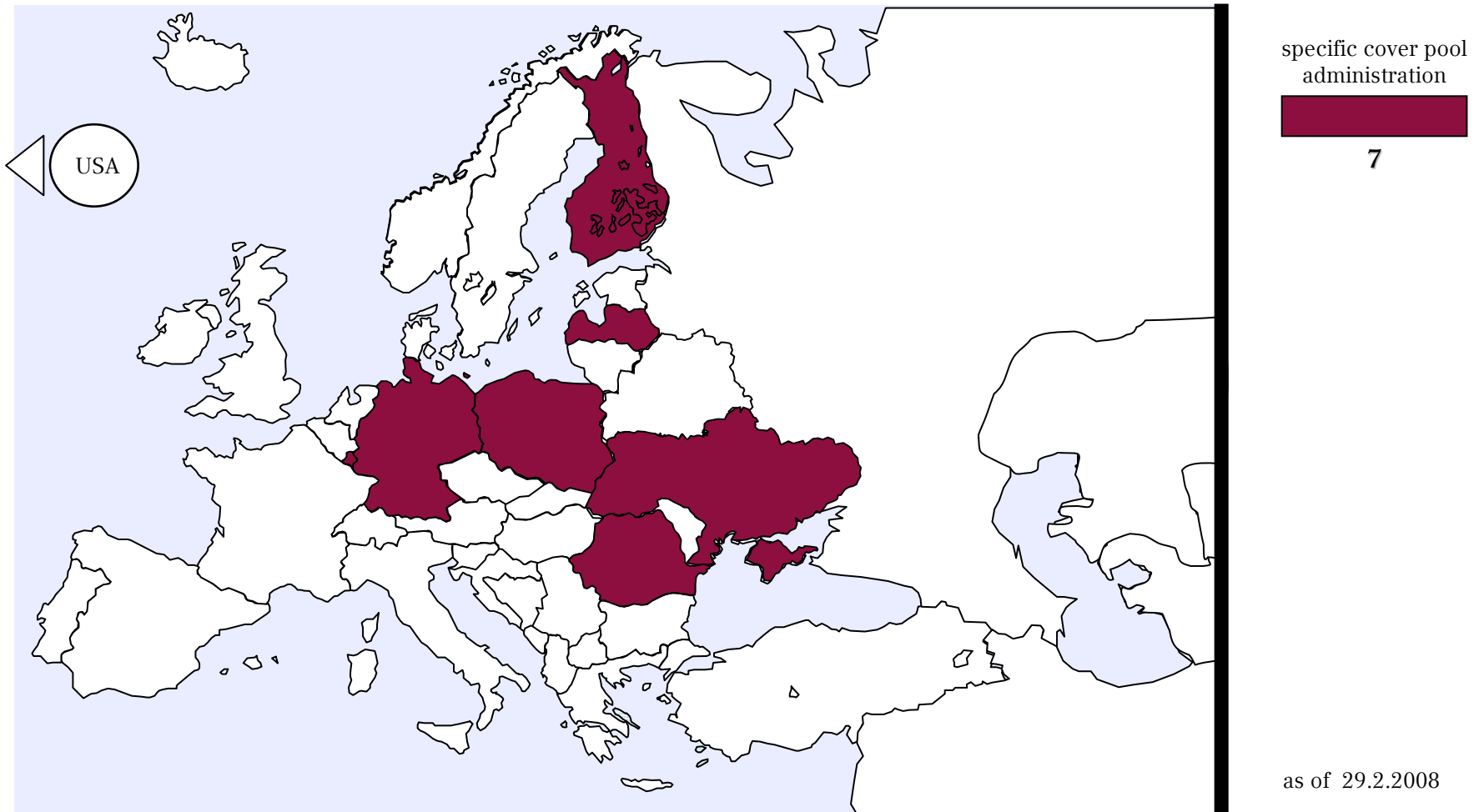


## 7. ECBC Comparative table VII. Segregation of assets & bankruptcy remoteness



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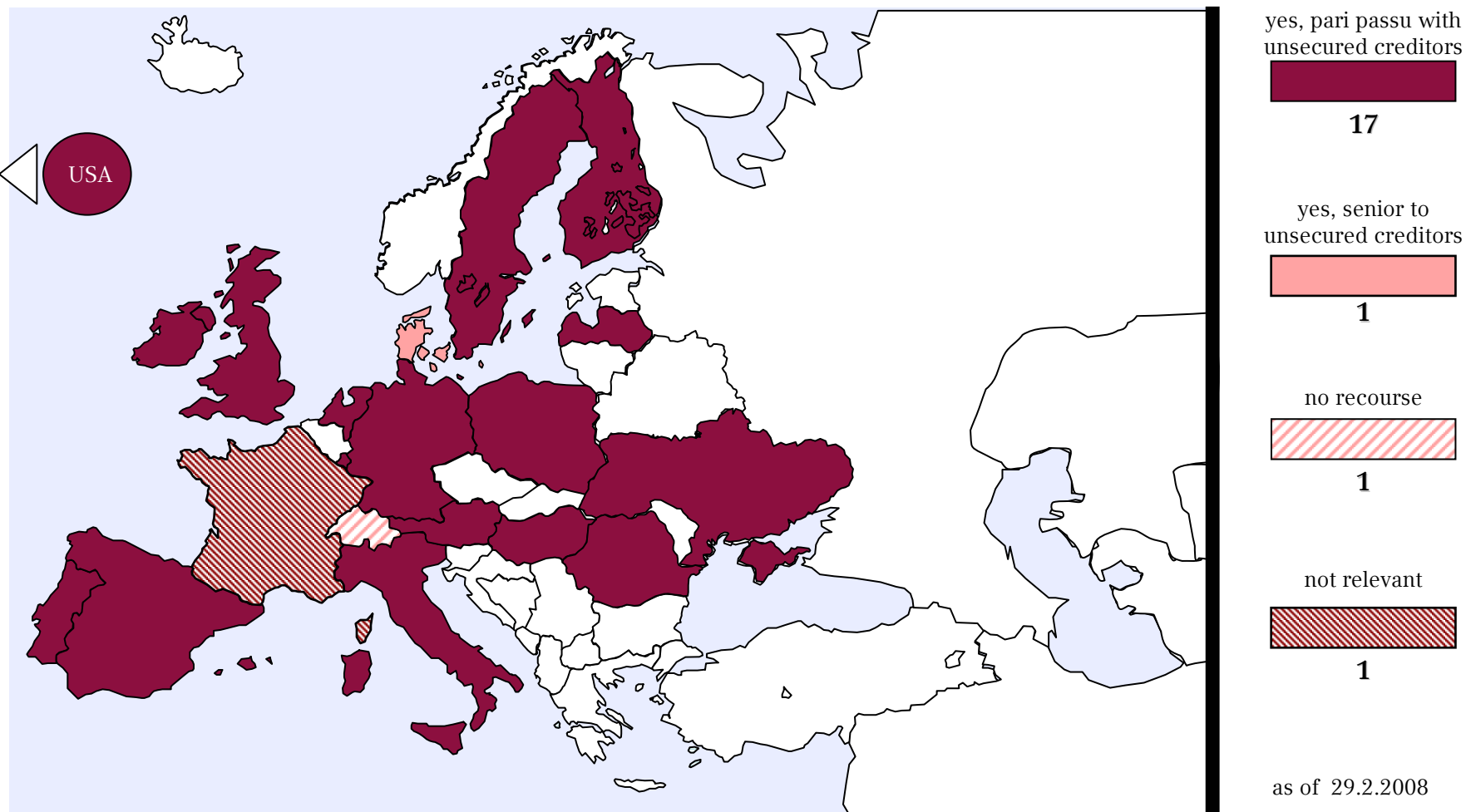


## 7. ECBC Comparative table VII. Segregation of assets & bankruptcy remoteness



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### VII.4: Is there recourse to the issuer's insolvency estate upon a cover pool default?



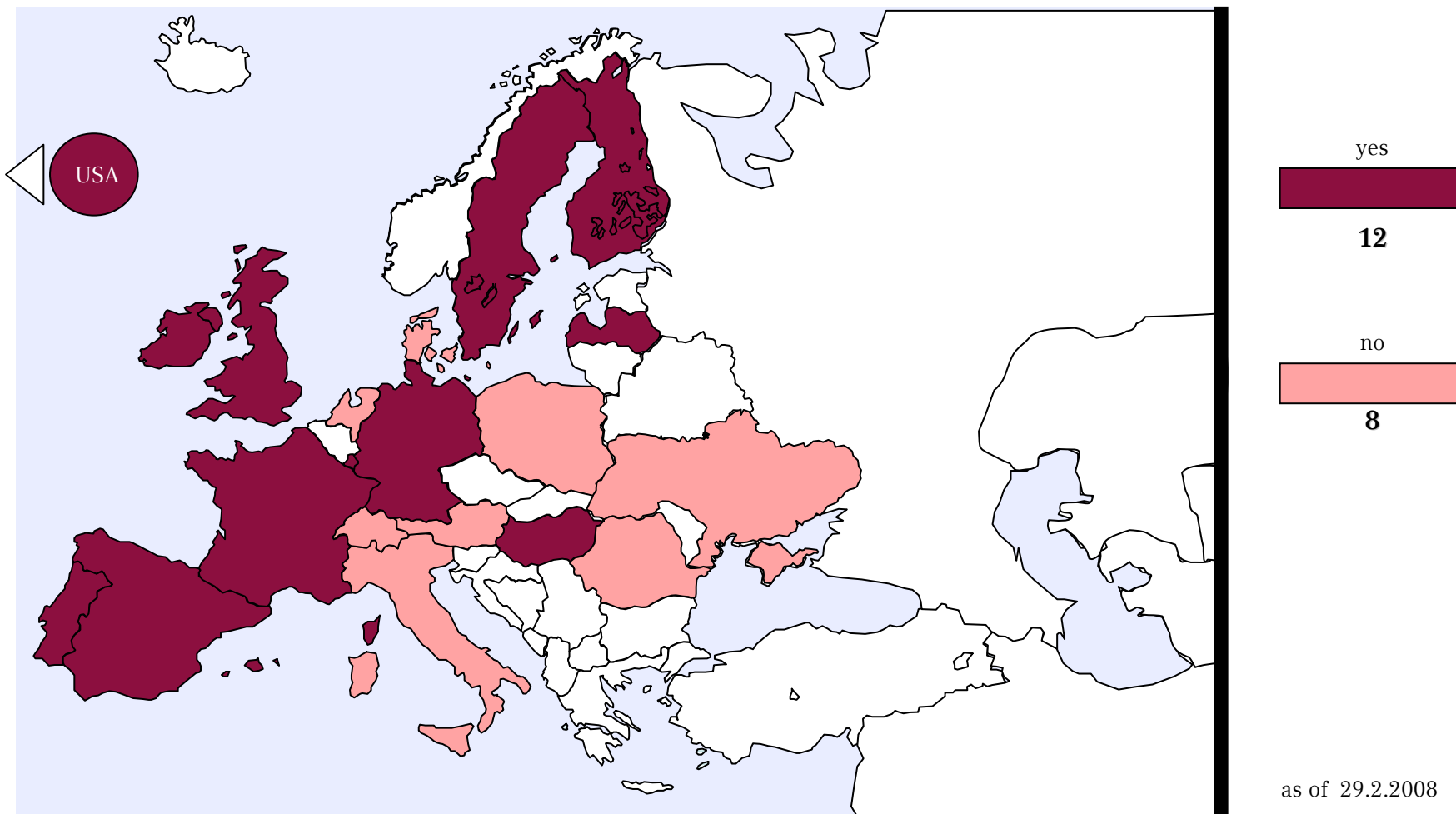


## 7. ECBC Comparative table VII. Segregation of assets & bankruptcy remoteness



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VII.5: Are there provisions that require derivatives to continue in case of insolvency of the issuer?



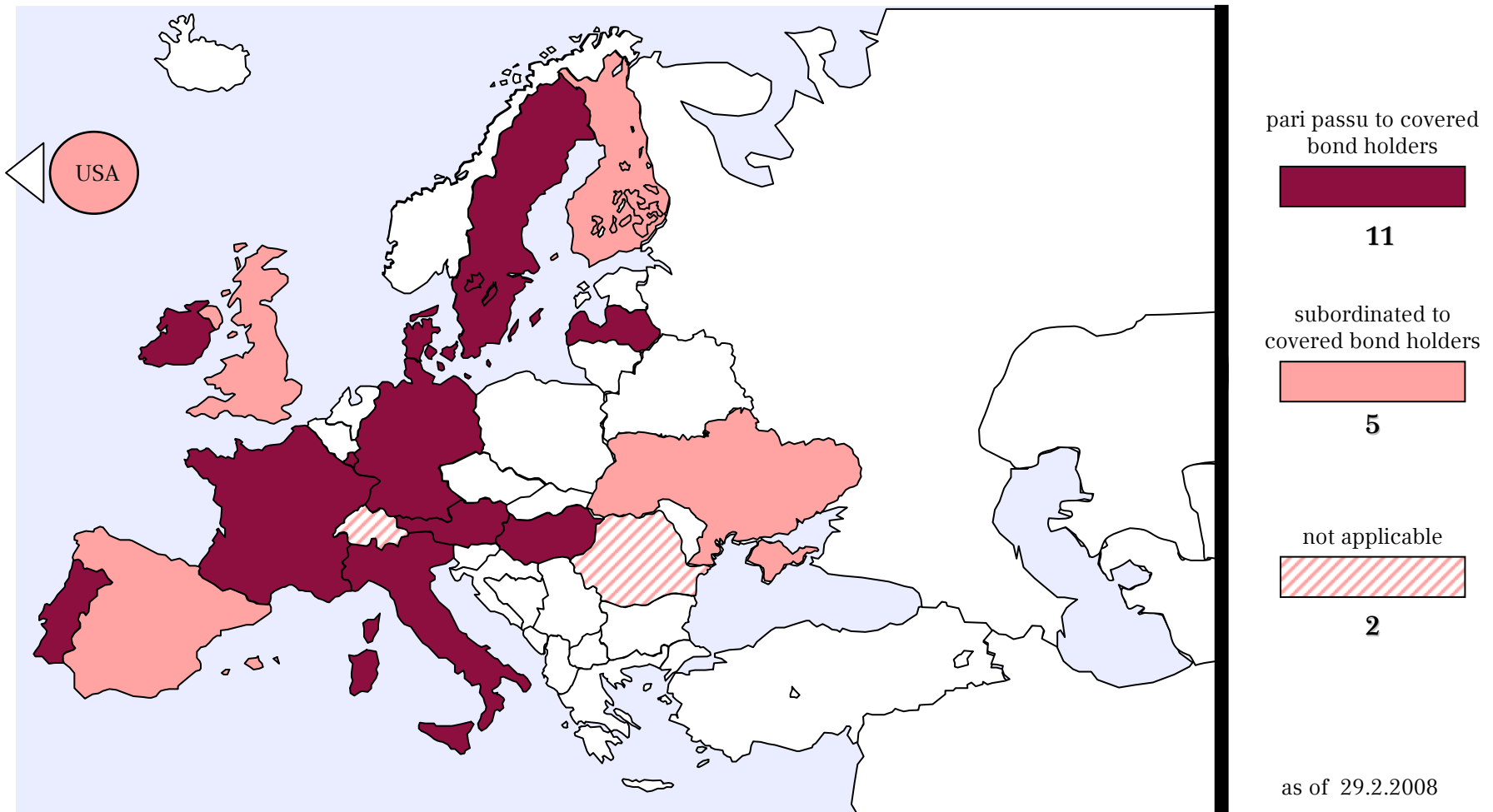


## 7. ECBC Comparative table VII. Segregation of assets & bankruptcy remoteness



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VII.6: If derivatives are permitted in the cover pool, what is their ranking?



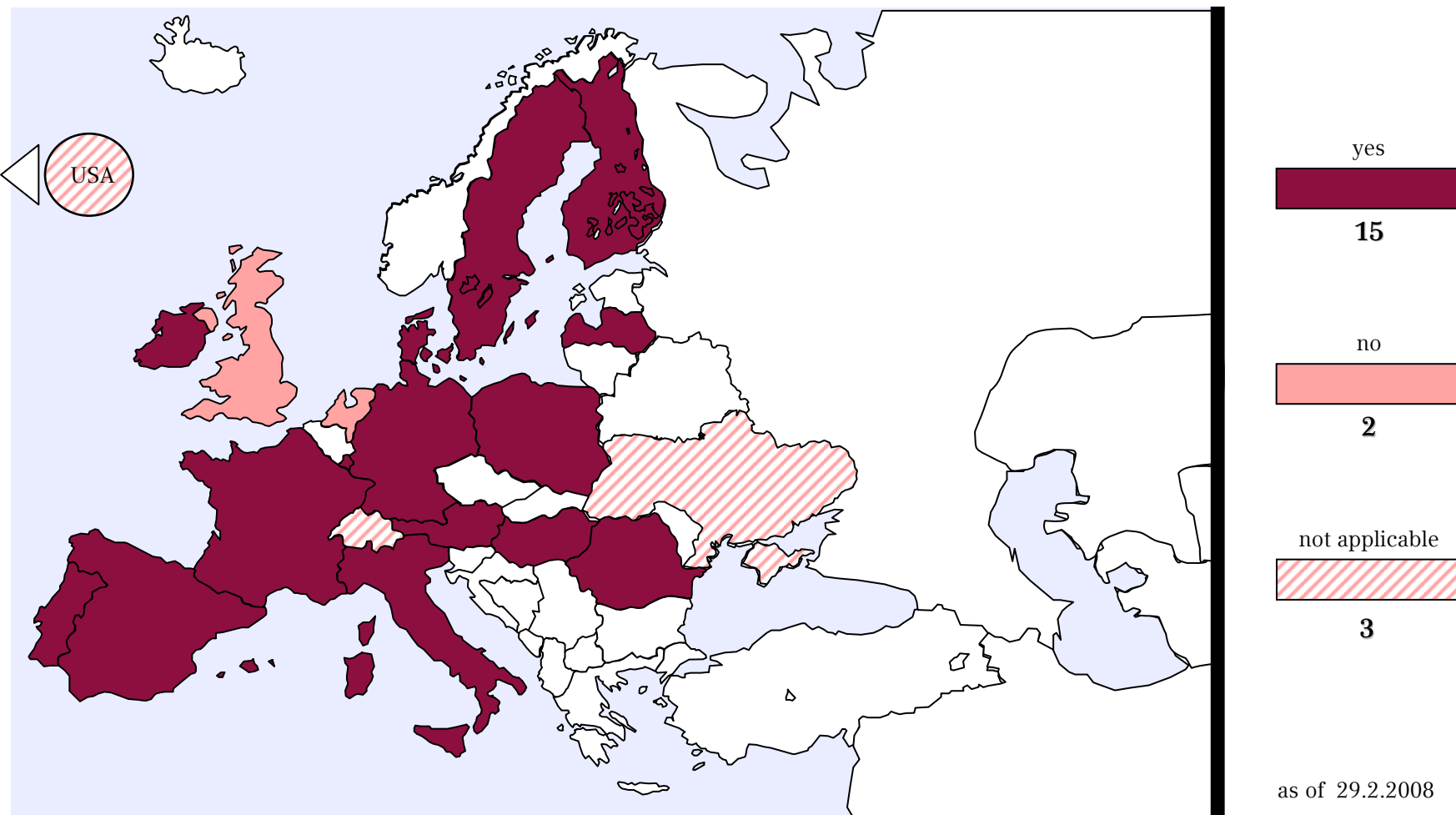


## 7. ECBC Comparative table VIII. Risk weighting & compliance with European legislation



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### VIII.1: Does the covered bond fulfill the criteria of UCITS 22(4)?



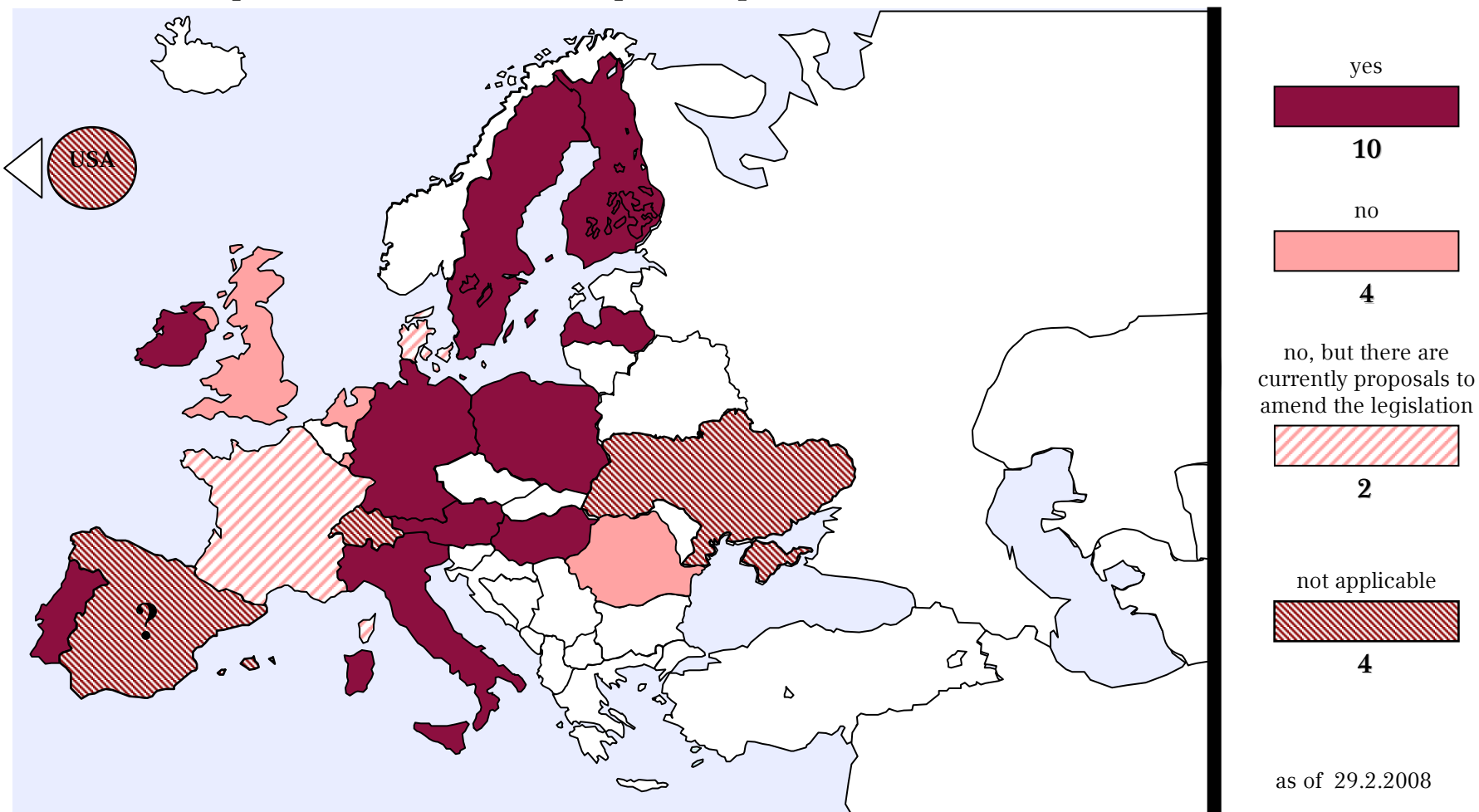


## 7. ECBC Comparative table VIII. Risk weighting & compliance with European legislation



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VIII.2: Does the covered bond legislation completely fall within the criteria of Annex VI, Part 1, para 68 (a) to (f) of the Capital Requirements Directive (CRD) 2006/48/EC?



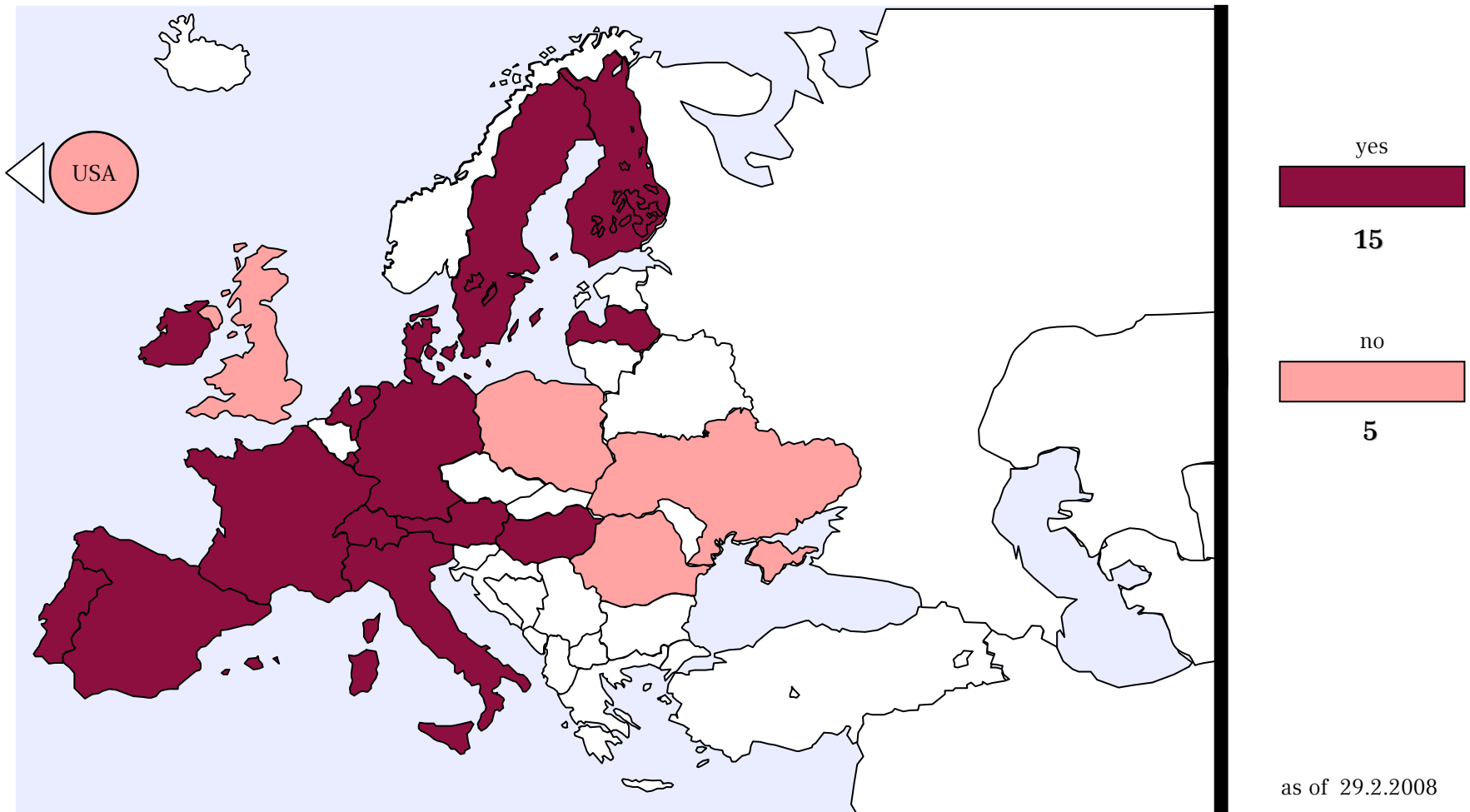


## 7. ECBC Comparative table VIII. Risk weighting & compliance with European legislation



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VIII.3: Are listed covered bonds eligible in repo transactions with the national central bank?



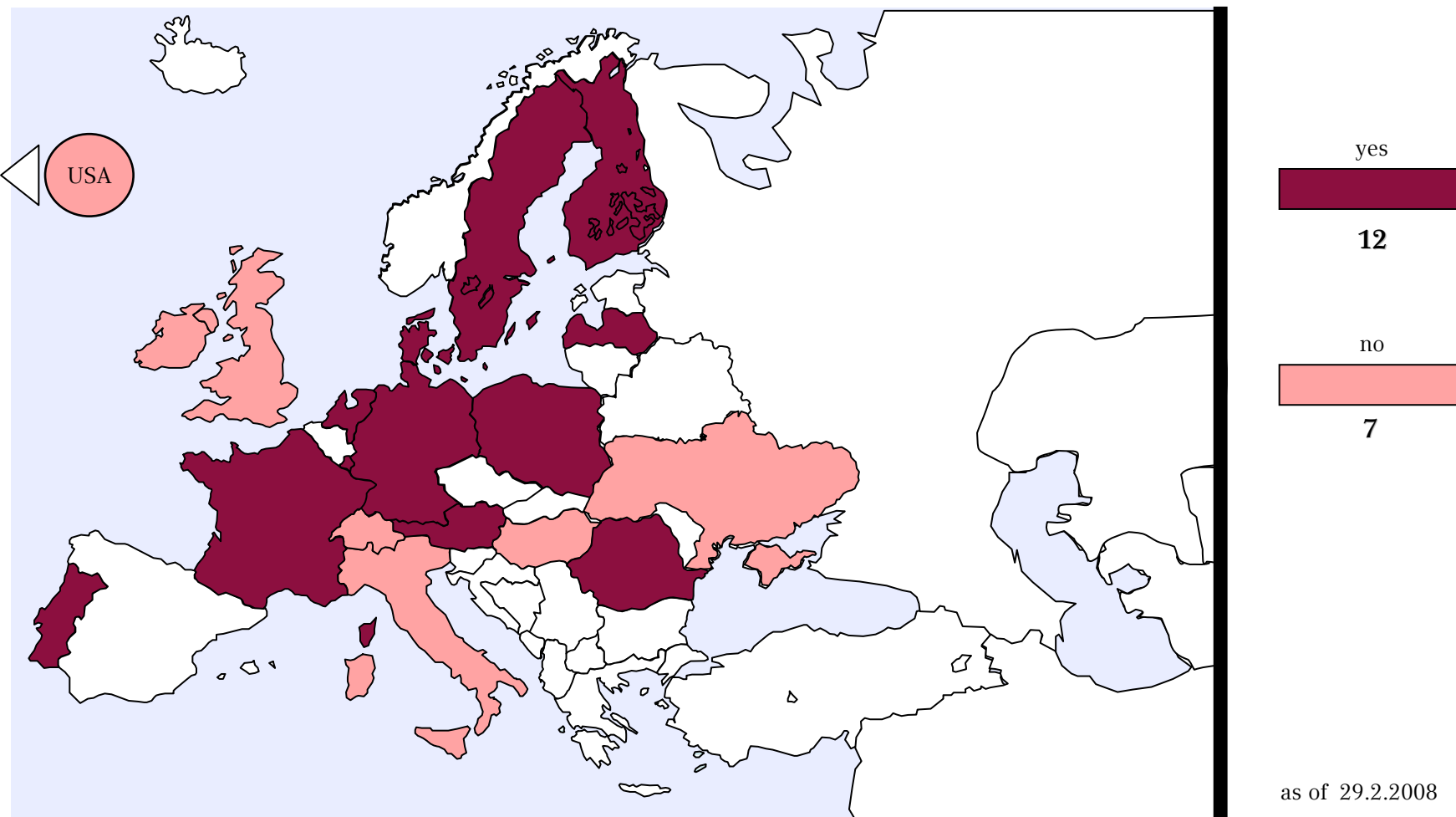


## 7. ECBC Comparative table VIII. Risk weighting & compliance with European legislation



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### VIII.4: Are there any special investment regulations regarding covered bonds?





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