



# Pfandbrief

THE PFANDBRIEF – QUALITY MADE IN GERMANY

vdp  
VERBAND DEUTSCHER  
PFANDBRIEFBANKEN  
Association of German Pfandbrief Banks

## The Pfandbrief system – responsible lending and stable funding

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gtz Beijing, 15 October 2010



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## **vdp is the lobbying body of Germany's Pfandbrief banks**

- ▶ **36 member banks** represent almost 100 % of new issuance volume and more than 95 % of outstanding Pfandbrief
- ▶ Analysis and continuous refinement of Pfandbrief system in more than 20 expert committees
- ▶ Think tank for any issues related to Pfandbrief
- ▶ International Pfandbrief marketing activities
- ▶ [www.pfandbrief.org](http://www.pfandbrief.org)



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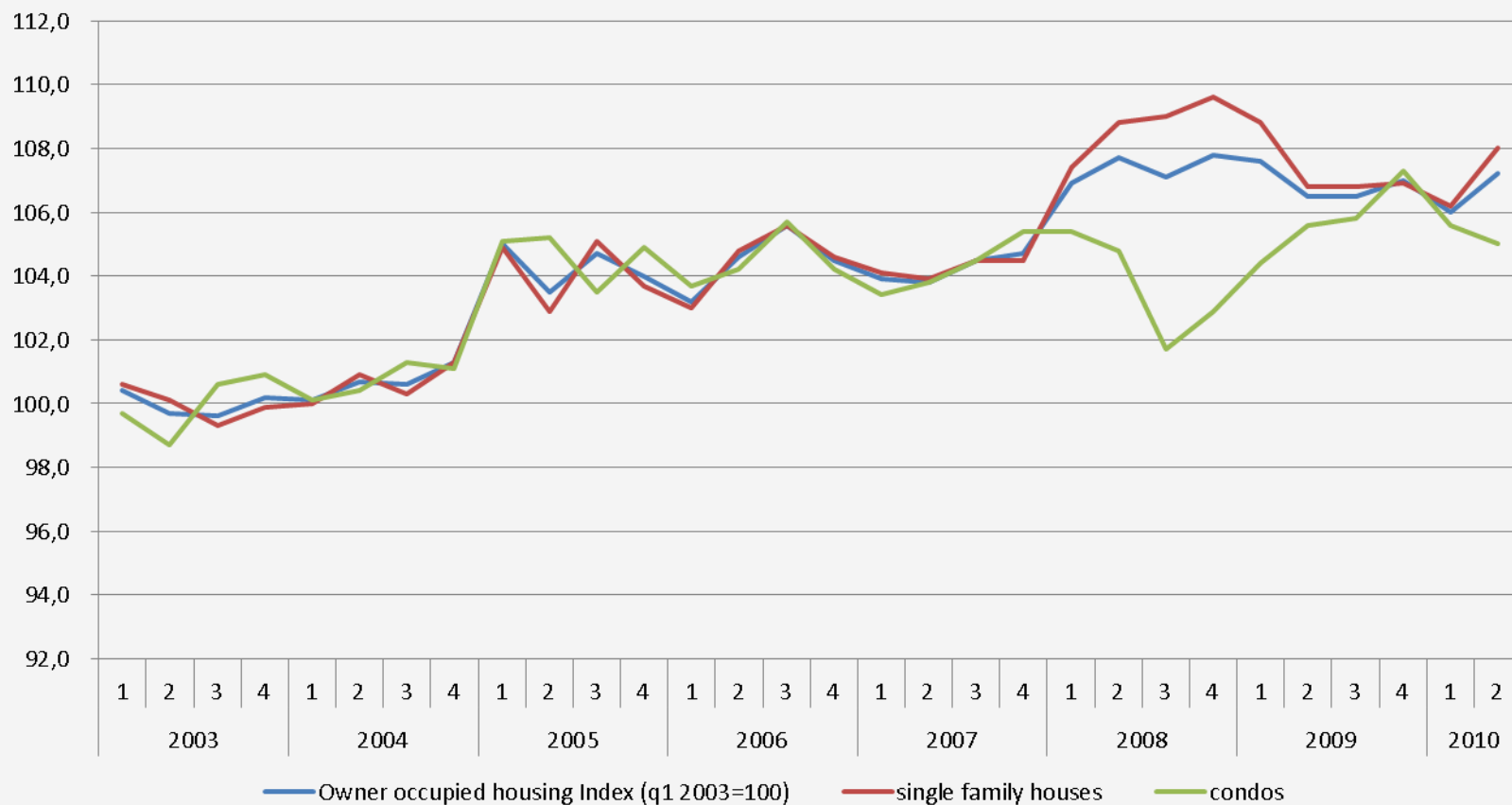
- I. **The Pfandbrief – contributing towards financial stability**
- II. Economic rationales of mortgage market funding via Pfandbrief
- III. Wrapping it up and looking ahead



# I. The Pfandbrief – contributing towards financial stability

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## vdp index for owner occupied housing (q1 2003=100)



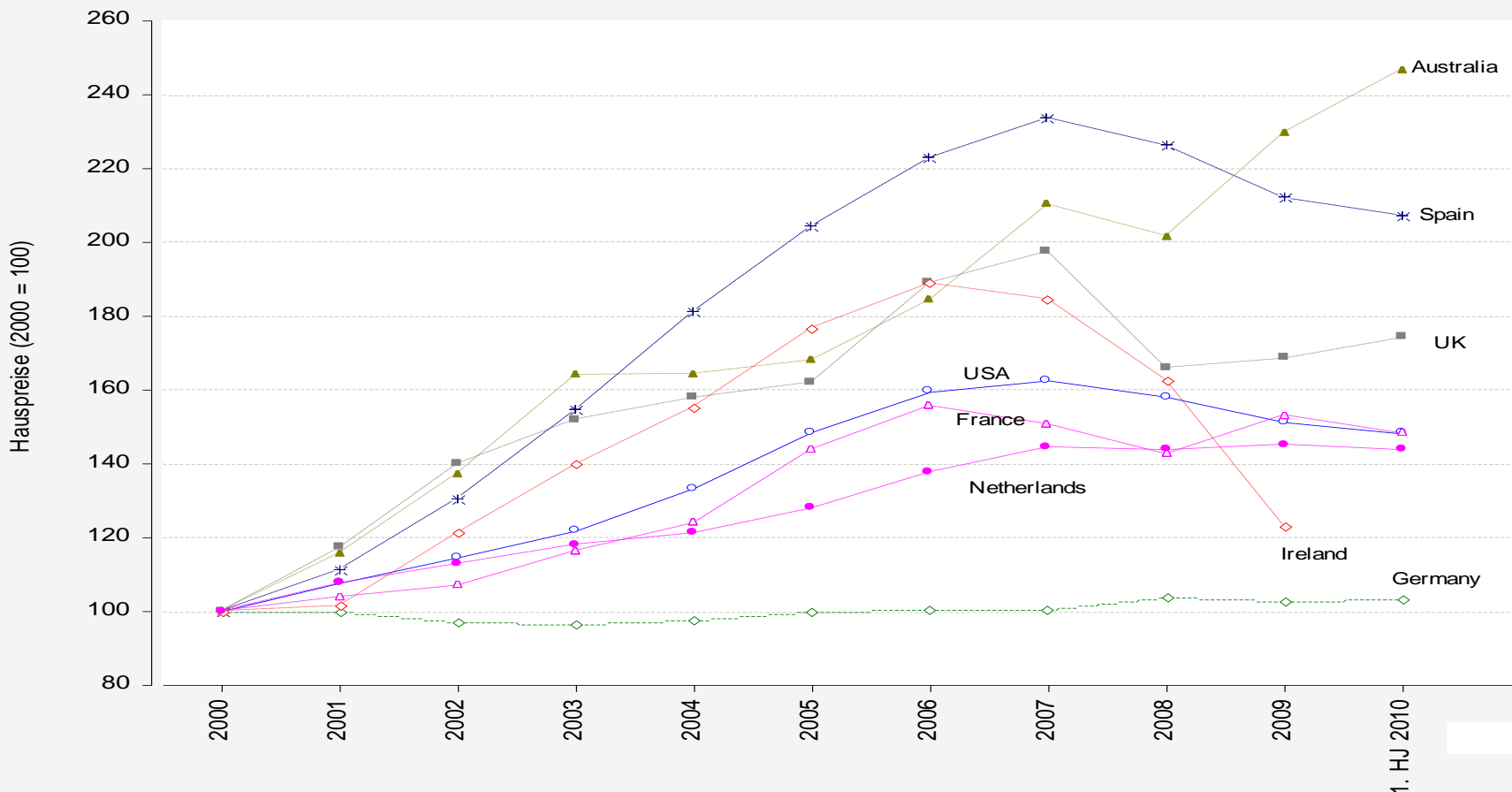
source: vdp research



# I. The Pfandbrief – contributing towards financial stability

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## House- and apartment prices - selected countries (2000 = 100)



sources: vdpResearch, national statistics, BIS



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## I. The Pfandbrief – contributing towards financial stability

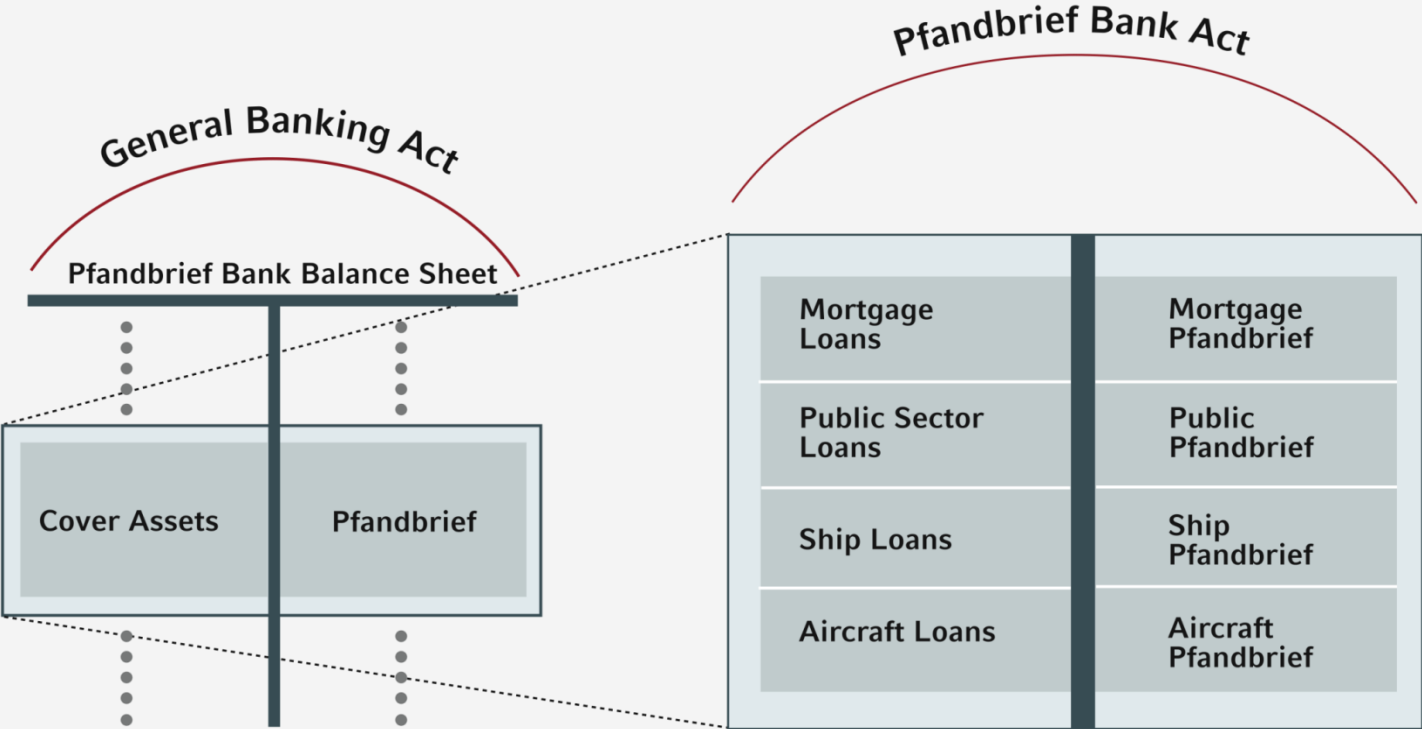
### **General characteristics of the German residential property market**

- ▶ Low home ownership ratio (approx. 45%)
- ▶ Substantial and affordable rental market is always accessible
- ▶ Property is a „once in a lifetime“ investment
- ▶ Fixed rate mortgages are preferred vehicle
- ▶ No subprime segment
- ▶ High stability and crisis resilience of German housing and housing finance market
- ▶ Many funding instruments compete – Pfandbrief among them



# I. The Pfandbrief – contributing towards financial stability

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the legal basis is key



## I. The Pfandbrief – contributing towards financial stability

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### **The Pfandbrief Act - investor protection as route towards stability in funding and...**

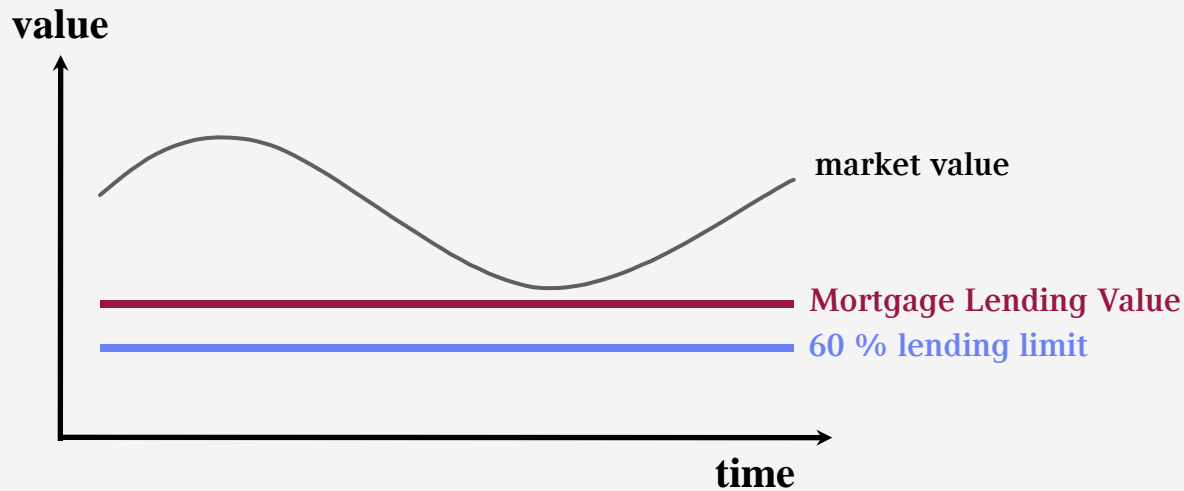
- ▶ License requirement for issuers
- ▶ „Ring-fencing“ protects cover pool assets from other banking business in case of issuer insolvency
- ▶ Special supervision by BaFin
- ▶ Special risk management requirements for Pfandbrief business
- ▶ Transparency and regular disclosure requirements
- ▶ Strict regulations on loan appraisal: Mortgage Lending Value



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## ...lending – conservative appraisal of Mortgage Lending Value



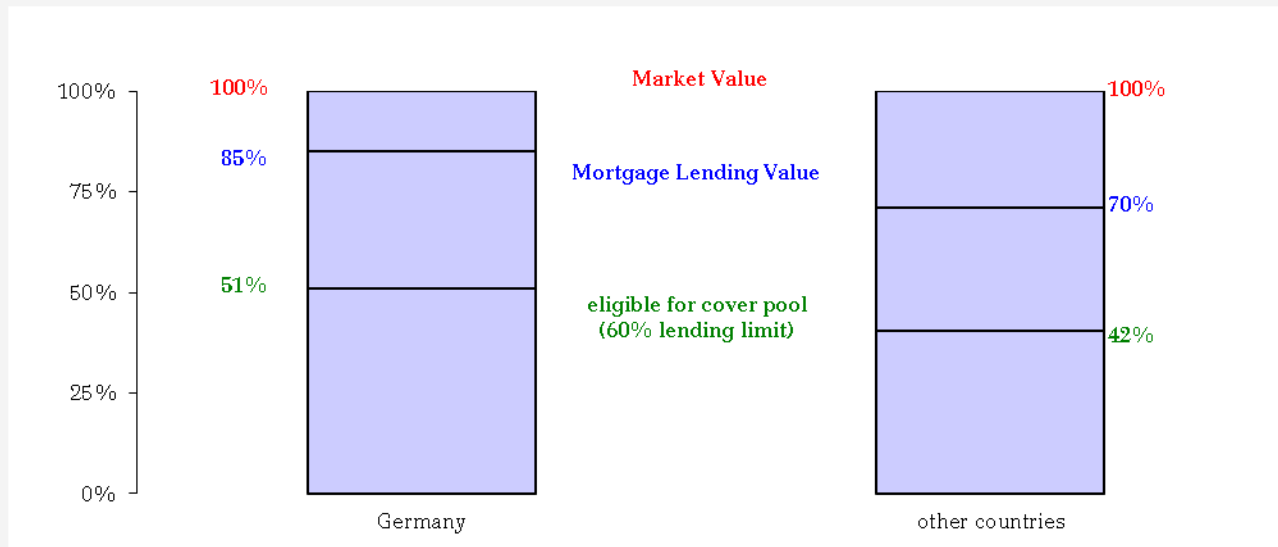
- Appraisal of Mortgage Lending Value according to detailed legal stipulations
- Based on sustained features of mortgaged property
- Market value is upper limit for Mortgage Lending Value
- Only senior loan tranches up to 60% of Mortgage Lending Value eligible for cover
- Regulations on the revision of appraised values



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# I. The Pfandbrief – contributing towards financial stability

## Conservative appraisal of Mortgage Lending Value - an example



- Property in Germany: relation between Mortgage Lending Value and market value: 85%
- Property outside Germany: relation between Mortgage Lending Value and market value due to conservatively determined rents and yields: 70%
- Lending limit of 60% of Mortgage Lending Value applies to cross-border mortgage cover loans, too



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## I. The Pfandbrief – contributing towards financial stability

### **Fixed rate mortgage – making home ownership foreseeable, plannable and affordable**

- ▶ 10 year fixed rate mortgages are the preferred tenor of home buyers in Germany
- ▶ Contractual pre-payment penalty
- ▶ Pfandbrief banks can channel through favorable capital market rates to retail clients
- ▶ Without pre-payment penalty mortgage rates would be higher, consumer benefit would diminish



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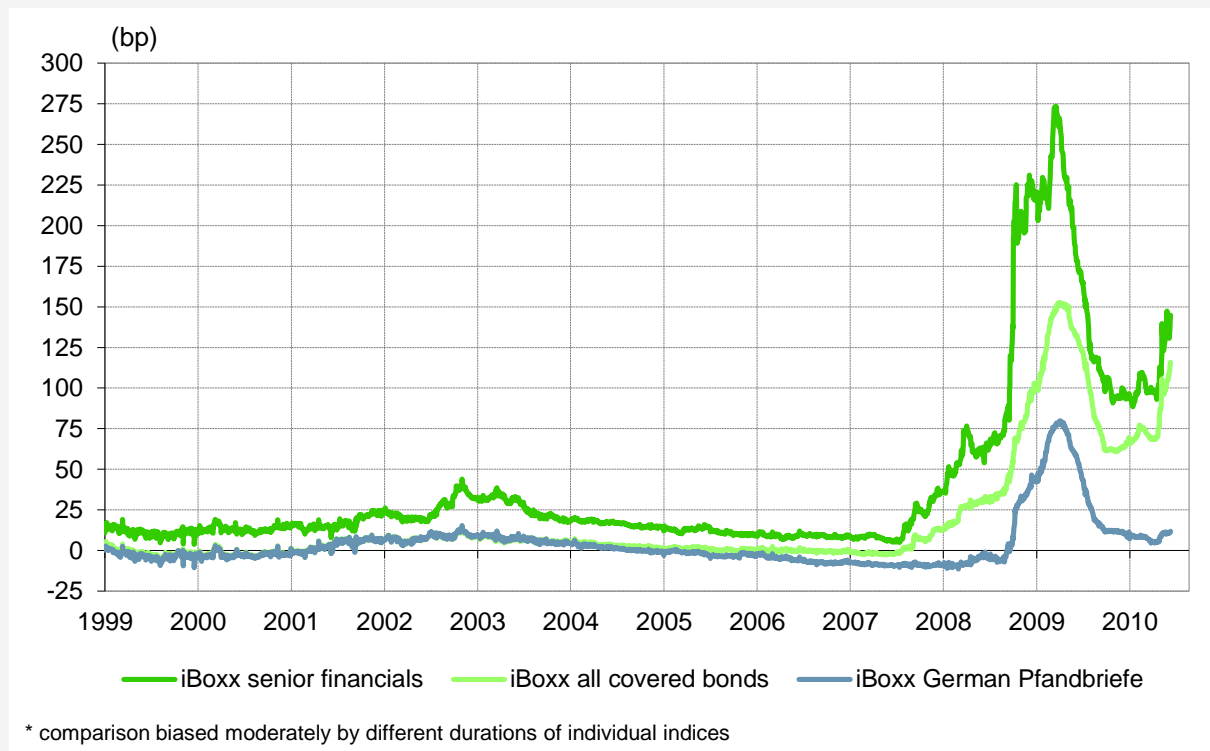
- I. The Pfandbrief – contributing towards financial stability
- II. Economic rationale of mortgage market funding via Pfandbrief**
- III. Wrapping it up and looking ahead



## II. Economic rationale of mortgage market funding via Pfandbrief

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### Overall development of swap spreads (bp)\* ...



source: Commerzbank Research



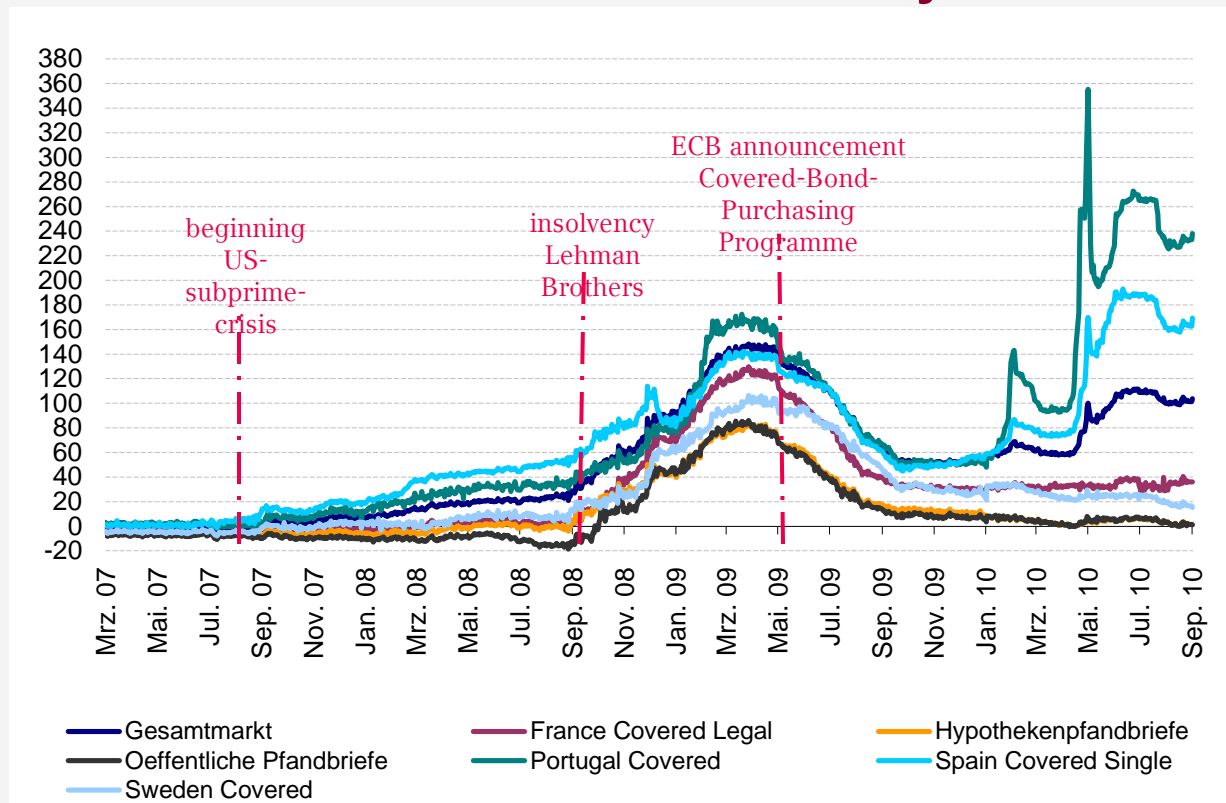
financial crisis increases benefit of covered funding



## II. Economic rationale of mortgage market funding via Pfandbrief

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### ... and in covered bond secondary markets



source: LBBW



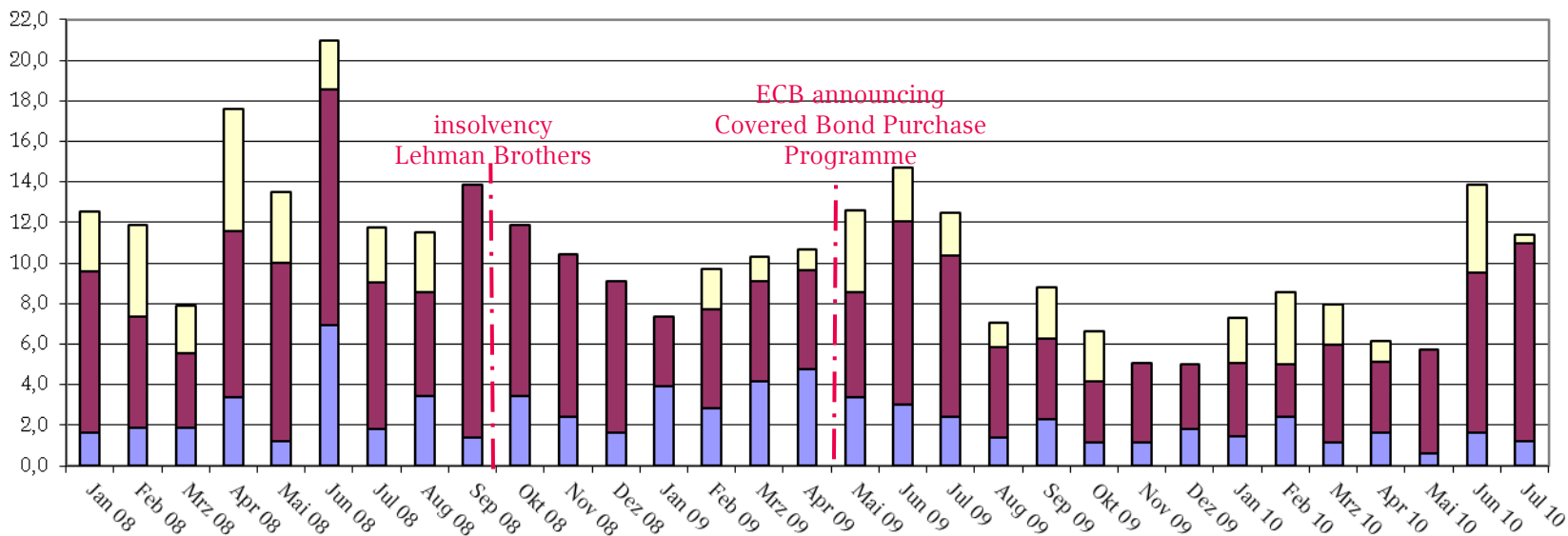
- Mortgage and Public Pfandbrief less affected by financial crisis than other covered bonds
- Covered bond spread universe has changed compared to before July 07
- differentiation has come to stay



## II. Economic rationale of mortgage market funding via Pfandbrief

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### Pfandbrief issuance 2008 – July 2010 (bn €)



	Jan. 08	Feb. 08	Mrz. 08	Apr. 08	Mai. 08	Jun. 08	Jul. 08	Aug. 08	Sep. 08	Okt. 08	Nov. 08	Dez. 08	Jan. 09	Feb. 09	Mrz. 09	Apr. 09	Mai. 09	Jun. 09	Jul. 09	Aug. 09	Sep. 09	Okt. 09	Nov. 09	Dez. 09	Jan. 10	Feb. 10	Mrz. 10	Apr. 10	Mai. 10	Jun. 10	Jul. 10
■ Jumbo (bearer-)Pfandbrief	2,9	4,5	2,3	6,0	3,5	2,4	2,7	3,0	0,0	0,0	0,0	0,0	0,0	2,0	1,3	1,0	4,0	2,7	2,1	1,3	2,5	2,5	0,0	0,0	2,3	3,5	2,0	1,0	0,0	4,4	0,4
■ Bearer Pfandbrief	8,0	5,5	3,7	8,2	8,8	11,6	7,2	5,1	12,4	8,5	8,0	7,5	3,4	4,9	4,9	4,9	5,2	9,0	7,9	4,5	4,0	3,0	3,9	3,2	3,6	2,6	4,8	3,5	5,1	7,9	9,8
■ Registered Pfandbrief	1,7	1,9	1,9	3,4	1,2	7,0	1,8	3,5	1,4	3,4	2,4	1,6	3,9	2,9	4,1	4,8	3,4	3,0	2,4	1,4	2,3	1,1	1,2	1,8	1,4	2,4	1,1	1,6	0,6	1,6	1,2

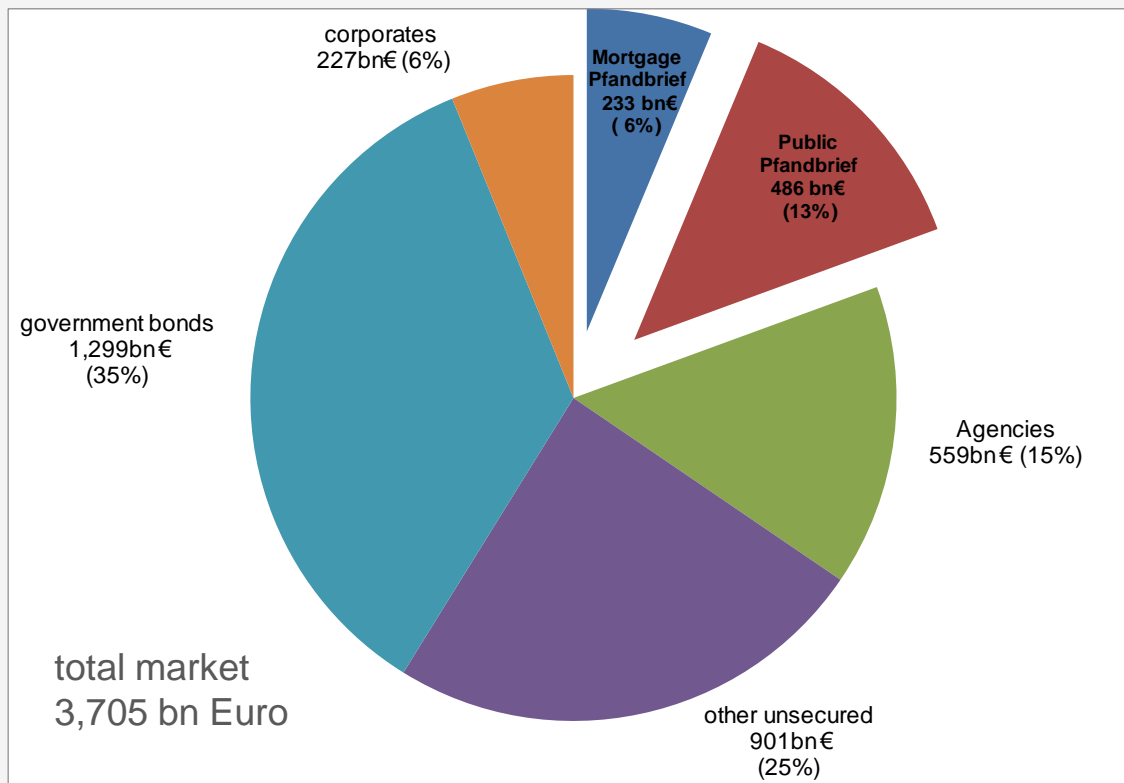
- Mortgage Pfandbrief\* 2009: 58 bn € 2008: 63 bn € 2007: 27 bn €
  - Public Pfandbrief 2009: 52 bn € 2008: 90 bn € 2007: 108 bn €
  - Pfandbrief total 2009: 110 bn € 2008: 153 bn € 2007: 135 bn €
- \*) incl. Ship Pfandbrief



## II. Economic rationale of mortgage market funding via Pfandbrief

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### The Pfandbrief in the German bond market (Dec 2009)



total German bond market 3,705 bn € of which Pfandbrief 719 bn Euro (19.4 %)



## II. Economic rationale of mortgage market funding via Pfandbrief

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### Market shares of vdp member banks in loan business 2009

- ▶ Property lending Germany
  - 34% (451bn Euro) of 1,345bn Euro total, of which
    - commercial loans 153bn Euro or 61% of 250bn Euro total,
    - residential loans 298bn Euro or 27% of 1,095bn Euro total
  
- ▶ Public sector lending in Germany
  - 48% (161bn Euro) of 335bn Euro total

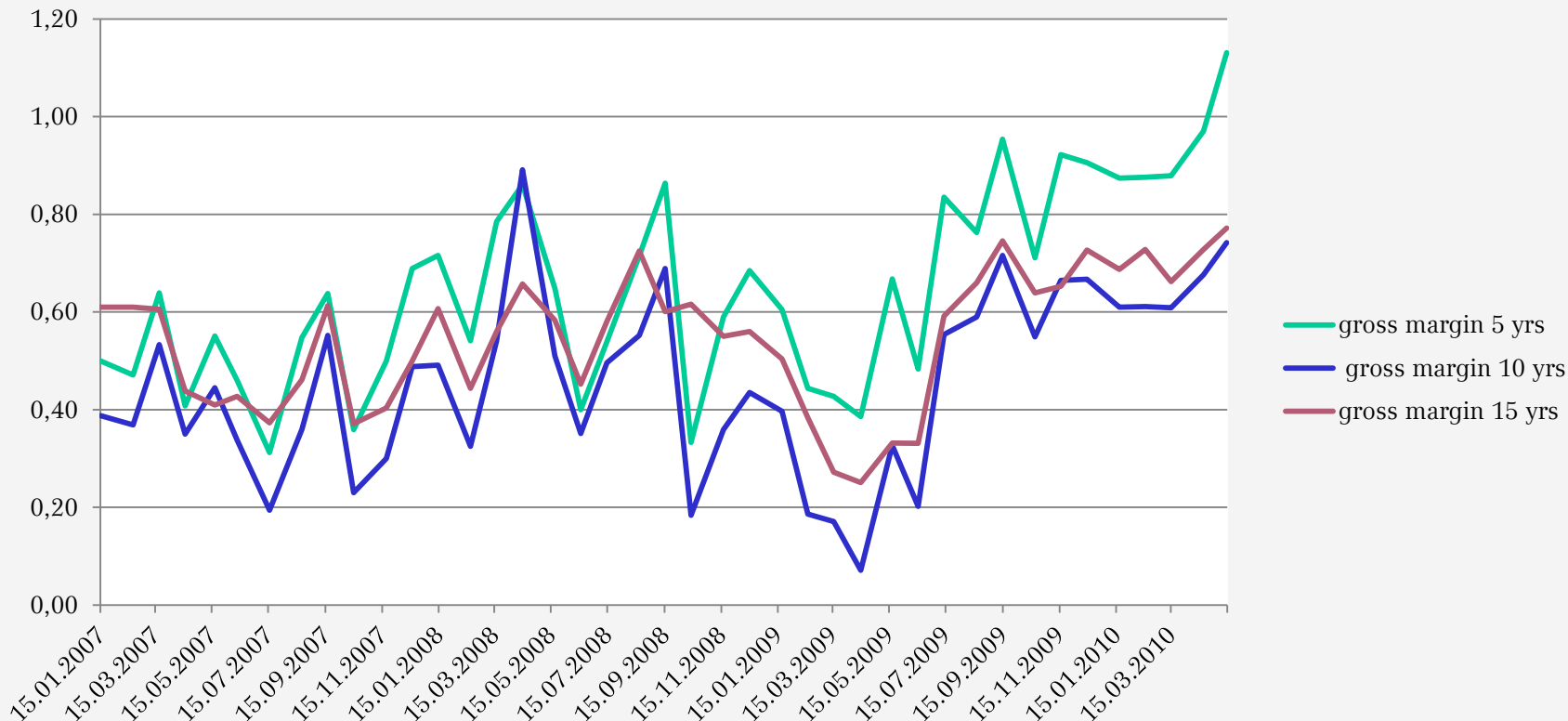
source: Deutsche Bundesbank



## II. Economic rationale of mortgage market funding via Pfandbrief

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### Gross margins Pfandbrief banks (pp)



source: vdp Pfandbrief Curves, own calculations



stable gross margins in residential lending of Pfandbrief banks – somewhat positive trend



## II. Economic rationale of mortgage market funding via Pfandbrief

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### Alternative means of funding – a comparison

	deposits	senior unsecured	Pfandbrief	GGBs	MBS
<b>cost of capital</b>	low	high	low	medium	medium
<b>distribution cost</b>	high	low	low	low	low
<b>cost of documentation</b>	low	medium	medium	medium	high
<b>capital relief</b>	low	low	low	low	high
<b>asset liability matching</b>	low	medium	high	medium	medium
<b>permanent access to liquidity</b>	high	low	high	high	low

source: vdp



## II. Economic rationale of mortgage market funding via Pfandbrief

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### In brief

- ▶ The Pfandbrief is very competitive especially in first ranking mortgages
- ▶ Competitiveness based on sound legal framework and market size and depth
- ▶ Deposit-based lending competitive especially in second mortgages
- ▶ Competitiveness of deposits as funding base increased during crisis when financial markets dried up especially for unsecured bank debt
- ▶ Access to deposits helps competitiveness in times of stress and with regard to second mortgages, BUT:
  - Asset-liability mismatch in deposit funding is critical, Pfandbrief is an appropriate and consistent funding instrument for long-term loans
  - Deposits are volatile and therefore ideally suited to short-term funding
  - German „long-termism“ is based on Pfandbrief



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- I. The success and systemic advantages of the Pfandbrief
- II. Economic rationale of mortgage market funding via Pfandbrief
- III. **Wrapping it up and looking ahead**



### III. Wrapping it up & looking ahead

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## The Pfandbrief system – long term lending and funding as pillar of stability

- ▶ On balance financing and funding incentivizes high underwriting standards and provides transparency in capital markets
  - ▶ Pfandbrief allows to tap investor potential at the medium and longer end of the curve
    - Preferred Pfandbrief tenor between 5 and 7 years
    - Pfandbrief banks provide investors with long dated liabilities such as insurance companies and pension funds with longer maturities, too, mostly in registered format
  - ▶ Mortgages with fixed interest rates prevail in loan origination
    - 10 years and fixed rate is preferred mortgage maturity
    - pre-payment penalty
    - fixed rate mortgages provide transparency, safety and efficiency for consumers
- => Stable long term finance and funding provide the ground for stable property market development**



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### III. Wrapping it up & looking ahead

## Issues to consider when introducing covered bond systems

- ▶ General issuing right vs. specialist bank principle
  - ▶ Will (large) universal banks be committed to the product much the same way as (smaller) specialist banks?
  - ▶ Does general legislation appropriately address key risks identified by other stakeholders – and is a covered bond system therefore likely to fulfill its role as reliable and cheap funding instrument?
  - ▶ Sound safety framework
  - ▶ Asset classes
  - ▶ Potential market size and depth
  - ▶ Investor base (domestic/international)
- => Only when general and dedicated conditions are carefully considered a covered bond system is likely to perform as a reliable and efficient funding instrument for property markets**



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### III. Wrapping it up & looking ahead

## Lessons learned from financial disruptions

demand for	status quo with Pfandbrief
tighter regulation	Pfandbrief Act including secondary regulation provides a stringent regulatory framework
tighter supervision	in addition to general supervision based on German Bank Act dedicated supervision of Pfandbrief business is demanded by Pfandbrief Act
simple structures	Pfandbrief design with the aim of investor protection basically unchanged for more than 200 years
responsible business conduct of banks	all Pfandbrief cover assets are kept on the balance of the issuer
increased transparency	Pfandbrief Act requires compliance with strict disclosure standards
regulation of rating agencies	Pfandbrief Act establishes strict quality standards; Supervisory authorities control compliance; Rating agencies of minor importance



## Contact

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## Annex: Mortgage Covered Bonds (MCB) vs. MBS

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	<b>MCB</b>	<b>MBS</b>
issuer	the issuer is an operating entity, i.e. a bank	issuer is an SPV
claim	investor has dual claim: issuer & collateral incl. respective cash flows; claims of bond holders rank pari passu	investor has a claim on collateral and its cash-flows depending on purchased tranche (senior or junior)
balance sheet treatment of originator	assets remain on-balance of issuer	assets (or associated risks) are transferred onto an SPV
homogeneity	high degree of standardization within a legal framework	low degree of standardization given contractual basis
cover pool	dynamic & actively managed - new assets enter as others mature	mostly static and well defined; assets remain in SPV
supervision	mostly specific supervision of covered bond issuers	SPV generally not specifically supervised
issue structure/ prepayment risk	bullet format, therefore no prepayment risk assumed by investor	amortization is common therefore prepayment risk assumed by investor






































## MCB vs. MBS continued

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	<b>MCB</b>	<b>MBS</b>
capital weighting	mostly 10 % in standardized approach, advantageous assumptions in IRB	depends on rating
credit risk	assumed by issuer	assumed by investors
servicing	by issuers	by separate servicer
valuation of loans and LTV's	legal requirements regarding valuation, conservative LTV	market values; no LTV requirements
disclosure rules	partly stipulated by law	depend on individual transaction
rating methodologies	partly “fundamental”, i.e. dependent on issuer credit, and partly structured finance, i.e. independent of issuer credit	structured finance approach
liquidation	insolvency remoteness of cover pools	insolvency remoteness of SPV

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 Deutsche Schiffsbank	 DEXIA Kommunalbank Deutschland	 Düsseldorfer Hypothekenbank	 DVB	 EURO HYPO	 Haspa <sup>®</sup> Hamburger Sparkasse
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