

Changes to the German *Pfandbrief* Act

On 12 February 2009, the first chamber of the German Parliament (*Bundestag*) adopted a bill to amend the Covered Bonds Act or *Pfandbrief* Act (*Gesetz zur Fortentwicklung des Pfandbriefrechts* – the "**Amendment Act**"). The Amendment Act aims to further improve the legal framework for the issuance of *Pfandbriefe* and to introduce a number of technical refinements based on the experiences of market participants since the introduction of the *Pfandbrief* Act (*Pfandbriefgesetz* – "**PfandBG**") in 2005. The German Federal Council (*Bundesrat*) as the second chamber of the German Parliament can veto the adoption but is not expected to. The Amendment Act will enter into force on the day after its publication in the Federal Law Gazette (*Bundesgesetzblatt*).

1. Background

Pfandbriefe are medium to long-term covered bank bonds issued by German credit institutions whose banking licence covers *Pfandbrief* business (*Pfandbriefbanken*). They are secured or "covered" at all times by a pool of eligible cover assets that are recorded by the issuer (the *Pfandbriefbank*) in a cover register. The claims of the *Pfandbrief* investors are direct and unconditional claims against the *Pfandbriefbank*, but the cover assets are statutorily excluded from seizure, foreclosure and set-off by third party creditors. In the insolvency of the *Pfandbriefbank*, the cover assets are automatically segregated from the *Pfandbriefbank's* general insolvency estate and administered by one or two statutory trustees appointed by the court in order to satisfy the claims of the *Pfandbrief* investors.

One reason for the success of the *Pfandbrief* is its credit history, which shows not a single case of *Pfandbrief* default since more than 100 years. To a large extent, this is due to the strict legal requirements imposed on the quality of the cover assets, over-collateralisation requirements and the ongoing monitoring of *Pfandbriefbanken* by the German financial services regulator, the BaFin. The *Pfandbrief* has retained much of its attractiveness for investors and issuers despite the global financial crisis. In the first half of 2008, *Pfandbriefbanken* issued *Pfandbriefe* worth EUR 84 billion, although both trading and new issuances have decreased considerably since August 2008. Also, a considerable part of the rescue measures initiated by the German government in response to the financial crisis were aimed at stabilising the situation of certain issuers of *Pfandbriefe*. The establishment of government bailout funds also led to the appearance of certain state-guaranteed bonds, which are seen as a competing – in fact, very successfully competing – product especially in relation to large-issuance (Jumbo) *Pfandbriefe*.

2. Overview

The Amendment Act will bring the following changes:

- The Aircraft *Pfandbrief* will be introduced. The cover assets for this new class of *Pfandbriefe* may consist in loan claims secured by German registered aircraft mortgages or by equivalent non-German aircraft mortgages.
- The eligibility criteria for Public *Pfandbriefe* cover assets will be extended to claims against public authorities and central banks of certain non-EEA countries. Further amendments aim at adapting the PfandBG to the revised

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European Banking Directive 2006/48/EC (the "**Banking Directive**").

- The use of syndicated loans as cover assets will be facilitated through specifications dealing with the partial entry of cover assets into the cover register.
- The maximum term of ship mortgage loans eligible as cover assets will be increased from 15 to 20 years.
- A number of technical refinements will be introduced in order to modernise the PfandBG. Among them, the principle of nominal cover to be observed by *Pfandbriefbanken* will be re-placed by a modified present value and liquidity risk approach.

3. Introduction of Aircraft *Pfandbriefe*

The Amendment Act will introduce Aircraft *Pfandbriefe* as a new class of *Pfandbriefe* in addition to the already existing Mortgage *Pfandbriefe*, Public *Pfandbriefe* and Ship *Pfandbriefe*. The cover assets for this new class of *Pfandbrief* will consist of loan claims secured by German law registered aircraft mortgages or by equivalent non-German law aircraft mortgages.

This amendment relates back to a survey by the German government which came to the conclusion that loan claims secured by aircraft mortgages are equally eligible and secure for use as *Pfandbrief* cover assets as are loan claims secured by ship mortgages. Accordingly, the proposed legal framework for Aircraft *Pfandbriefe* is largely comparable to that for Ship *Pfandbriefe*.

Eligible loan claims secured by aircraft mortgages as cover assets for Aircraft *Pfandbriefe* may only be used up to 60 per cent of the value of the encumbered aircraft (lending value) as determined by an independent expert with the requisite knowledge. The determination of the lending value must be based on the future marketability of the aircraft and must not exceed the market value calculated in accordance with a recognised valuation method. Details will be set forth in a new Regulation on the Determination of Aircraft Lending Value (*Flugzeugbeleihungswertermittlungsverordnung*).

The term of a loan used as cover asset may only extend until the 20th anniversary of the encumbered aircraft, unless a shorter lifetime is to be expected. Furthermore, the aircraft must be insured (in accordance with the business terms of the *Pfandbriefbank*) in an amount of at least 110 per cent of the sum of the outstanding loan claim plus any prior or equal ranking aircraft mortgages of other creditors.

The legal basis for the encumbrance of aircrafts with a registered mortgage in Germany is set out in the Rights in Aircrafts Act (*Gesetz über Rechte an Luftfahrzeugen*), which largely corresponds to the relevant act on rights in registered ships.

German law aircraft mortgages are only valid upon their registration in the aircraft mortgage register (*Pfandrechtsregister*) held at the local court (*Amtsgericht*) in the city of Brunswick (*Braunschweig*). Only such aircrafts can be encumbered that are entered into the aircraft register (*Luftfahrzeugrolle*) maintained with the German Federal Aviation Authority (*Luftfahrt-Bundesamt*).

Loans secured by non-German aircraft mortgages may be used as Aircraft *Pfandbrief* cover assets if, in accordance with the laws of the country in whose register the aircraft is registered, (i) a right *in rem* is created in the aircraft which is recorded in a public register, (ii) the right *in rem* gives the creditor a security comparable to an aircraft mortgage under German law, in particular the right to seek satisfaction in regard of the secured claim, and (iii) if enforcement is not significantly more difficult for foreign creditors compared to nationals of that country.

The total volume of lendings outside the EU for which it is not ensured that the cover assets are automatically segregated from the general insolvency estate of the *Pfandbriefbank* and reserved for the claims of the *Pfandbrief* investors may not exceed 20 per cent of the total volume of lendings in respect of which such preferential right is ensured. Loans are generally only eligible as cover assets if they are secured by a first-ranking aircraft mortgage.

4. Public *Pfandbriefe* Cover Assets

Cover assets for Public *Pfandbriefe* are money claims resulting from loans, bonds or a comparable transaction or other money claims acknowledged in writing as being free from defences if they are directed against an eligible debtor or for which an eligible debtor has assumed a full guarantee.

Under the current version of the PfandBG, eligible debtors are (i) German public-sector authorities for which a maintenance obligation (*Anstaltslast*) or a guarantee obligation (*Gewährträgerhaftung*) or another state refinancing guarantee applies or which are legally entitled to raise fees, rates and other levies, (ii) the EU/EEA countries, Switzerland, the United States, Canada and Japan, (iii) regional governments and local authorities of the afore-mentioned states that have been assigned a risk weighting of not more than 20 per cent in accordance with article 43 para. 1 of the European Directive 2000/12/EC, (iv) non-profit administrative organisations that are subordinated to a central or regional government or a local authority within the EU/EEA (but not in respect of "other money claims" and not as guarantors of claims) that have been assigned a risk weighting of not more than 20 per cent in accordance with article 43 para. 1 letter b no. 6 in conjunction with article 46 of the European Directive 2000/12/EC, as well as (v) the European Investment Bank, the International Bank for Reconstruction and Development, the Council of Europe Development Bank and the European Bank for Reconstruction and Development.

In this context, the Amendment Act will bring the following changes:

- The central banks of the EU/EEA countries as well as the central banks of Switzerland, the United States, Canada and Japan will also qualify as eligible debtors. In the case of central banks of countries outside the EU/EEA, such a central bank must have been assigned a "credit quality step 1" as defined in Annex VI Table 1 of the Banking Directive (corresponding to a zero per cent risk weighting). Until now, only claims against central banks within the EU/EEA are eligible as substitute cover assets (that are, certain assets other than the aforementioned eligible cover assets that may be used as substitute cover for *Pfandbriefe* up to certain thresholds) and only up to 10 per cent of the nominal amount of all outstanding *Pfandbriefe*.
- The requirement of a maximum risk weighting of 20 per cent in respect of regional governments and local authorities as eligible debtors will be abolished. Non-EU/EEA public entities will only qualify as eligible debtors if they have been equated with the relevant central government or have been assigned "credit quality step 1" in accordance with Annex 6 Table 3 of the Banking Directive.
- The European Central Bank, multilateral development banks and international organisations (as defined in Annex VI of the Banking Directive) will become eligible debtors, too. The existing 10 per cent threshold in regard of the use of such claims as substitute cover assets will be abolished.
- Further eligible debtors will be "public sector entities" within the meaning of article 4 para. 18 of the Banking Directive (i.e. non-commercial administrative bodies responsible to central governments, regional governments or local authorities, or authorities that exercise the same responsibilities as regional and local authorities, or non-commercial undertakings owned by central governments that have explicit guarantee arrangements, including self administered bodies under public supervision) that are located within the EU/EEA or in Switzerland, the United States, Canada or Japan. As is the case for regional governments and local authorities, public sector entities outside the EU/EEA must have been assigned "credit quality step 1". However, public sector entities are only eligible to the extent the relevant claim is owed by them, guarantees issued by such public sector entities will not be sufficient.
- The Amendment Act also introduces further technical refinements as regards the definition of eligible guarantees and clarifies that export credit insurance companies qualify as eligible guarantors of cover assets. Only public sector export credit insurance companies within the meaning of article 2

of the European Directive 98/29/EC are eligible, i.e. institutions providing cover in the form of export credit insurance, guarantees or refinancing for the account or with the support of, or controlled by, the government of an EU/EEA country.

5. Syndicated Lendings

The Amendment Act also addresses the partial entry of cover assets in the cover register of *Pfandbriefbanken*. These changes relate in particular to the entry of syndicated loans into the cover register and to other cases where loans are not used as cover assets up to the maximum possible amount of 60 per cent of the mortgage lending value.

In particular, the Amendment Act provides that, insofar as assets registered in the cover register shall be used as cover assets in a partial amount only, the cover register must precisely specify this partial amount to be used as cover asset and its ranking in relation to the remaining amount. Furthermore, if registered cover assets are administered by the *Pfandbriefbank* as security trustee for third party creditors, the cover register must specify these creditors and the amount of their creditorship.

The main purpose of these new provisions is to facilitate syndicated lendings involving a *Pfandbriefbank* that holds security for the syndicate lenders as a security trustee (mostly in the role of the syndicate leader). In such a scenario, the *Pfandbriefbank* typically retains sole legal ownership in the mortgage that secures the syndicated loan and enters this mortgage in its cover register for *Pfandbriefe*. At the same time, the *Pfandbriefbank* will convey beneficial ownership in the mortgage to the other syndicate lenders (in the amount of their creditorship in the loan). It had sometimes been argued that the current cover register provisions would not adequately address this case so that registered cover assets also held on trust for others might possibly be segregated and used to satisfy the claims of the *Pfandbrief* investors upon the insolvency of the *Pfandbriefbank* in their entire amount, regardless of the claims of the other syndicate lenders.

The Amendment Act further clarifies that the transfer of personal (borrower-related) data (for example, from the secured party) to a *Pfandbriefbank* is permitted if the *Pfandbriefbank* requires such data for the entry of the relevant cover asset in its cover register.

What still remains unclear, however, is whether these changes also allow for a partial entry of other classes of cover assets than mortgage secured loans, such as derivatives and the different forms of substitute cover assets. While the relevant provisions in the Amendment Act are in principle drafted wide enough to permit this, the official reasoning to the Amendment Act relates exclusively to mortgage secured loans.

6. Ship Mortgages

Under the current PfandBG, the maximum term of ship mortgage loans used as cover assets is 15 years, and the ultimate repayment date of the loan may not be later than the 20th anniversary of the encumbered ship.

In the view of the German legislator, these criteria led to a factual discrimination of new ship financings regarding their use as cover assets because these can only be granted for a maximum term of 15 years and not over the full assumed lifetime of a ship of 20 years. In this context, it was also considered that the lifetime of standard ships (i.e. tankers, bulkers and container ships) is nowadays usually even more than 25 years. As a consequence, the requirement that a ship mortgage loan can only have a maximum term of 15 years will be abolished, however, the ultimate repayment date of the loan may still not be later than the 20th anniversary of the encumbered ship.

7. Technical Refinements

The Amendment Act will introduce a number of further technical changes. Among those are a modified approach for the calculation of adequate cover and the deletion of the so-called dual control requirement.

7.1 Present value cover and liquidity risk

Pfandbriefbanken must ensure that the total nominal amount of outstanding *Pfandbriefe* of one specific category is always covered by cover assets of at least equal value and interest rate. This principle of nominal cover will be replaced by a modified present value model and a new method for the protection against liquidity risk.

This means that outstanding *Pfandbriefe* will need to be covered at their present value, taking into account

redemption and interest payments. Now as before, the present value of the cover assets must exceed the present value of the outstanding *Pfandbriefe* by at least two per cent (statutory over-collateralisation).

This requirement will be supplemented by a method addressing the short-term liquidity risk of *Pfandbriefbanken*. This means the risk that, in the case of insolvency of the *Pfandbriefbank*, the pool of cover assets cannot generate enough liquidity to redeem those *Pfandbriefe* that become repayable within the next few months. The new method provides for the daily calculation of the amount of liquidity needed in respect of outstanding *Pfandbriefe* within a timeframe for the next 180 days. The amount so calculated must at all times be covered by liquid cover assets, such as transferable securities or credit balances with the European Central Bank or other suitable credit institutions.

7.2 Dual control

Pursuant to the old PfandBG, the statutory trustee (*Treuhänder*) of the *Pfandbriefbank* is required to ensure the safekeeping of the cover assets and the deeds relating to such assets under dual control with the *Pfandbriefbank*. This requirement pertains in particular to certificated land charges (*Briefgrundschulden*) that are represented by a physical certificate. The purpose of the dual control requirement in relation to such certificates was to avoid an unjustified disposal over the land charge by the *Pfandbriefbank*. However, since most of the newly created land charges nowadays are in the form of a registered land charge (*Buchgrundschuld*) for which no certificate is issued, it was considered that the dual control requirement can be abolished.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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