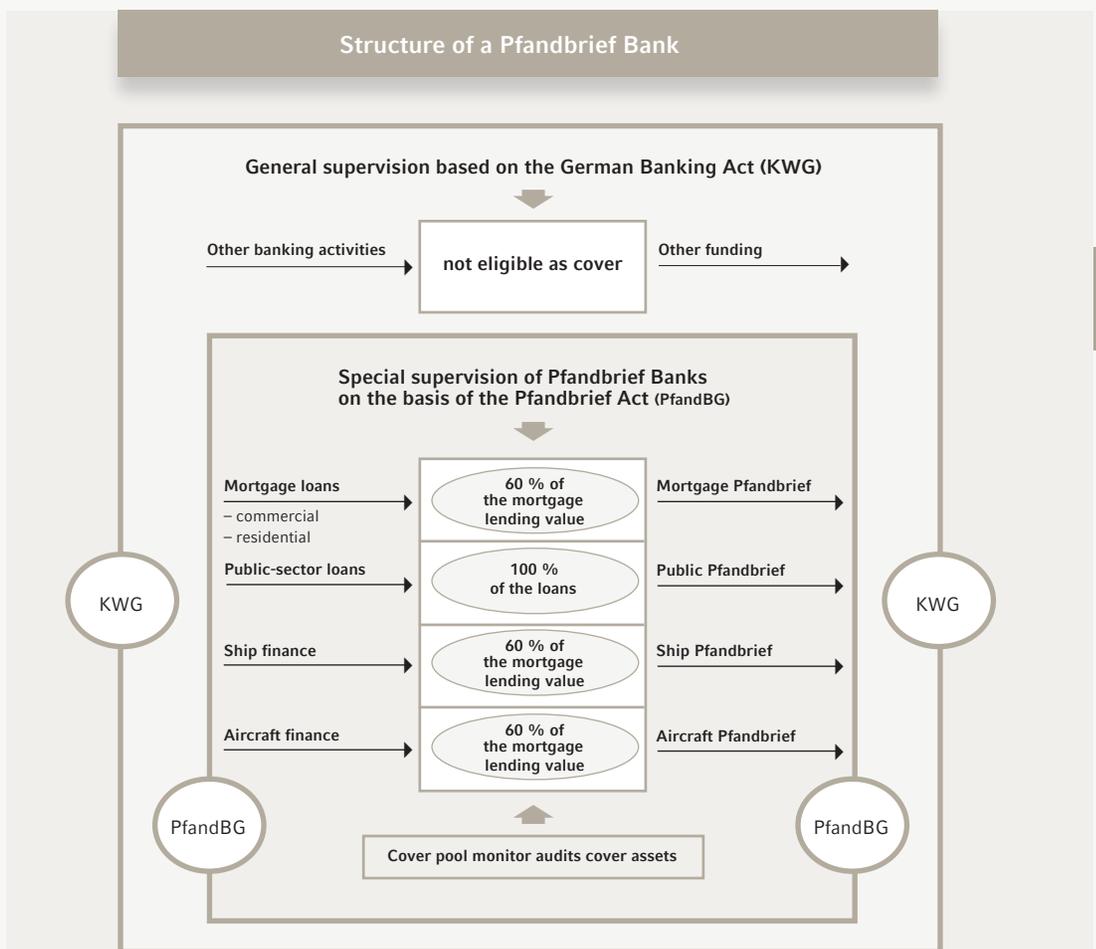


The Legal Framework for Issuing Pfandbriefe

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Pfandbriefe are covered interest-bearing bonds. They are issued by credit institutions with a license to engage in Pfandbrief business (Pfandbrief Banks) and placed on the capital market. These credit institutions use them to fund certain loans that are secured by real estate liens, ship mortgages, aircraft mortgages and claims against public-sector bodies. Depending on the type of collateralization, these bonds are referred to as Mortgage Pfandbriefe, Ship Pfandbriefe, Aircraft Pfandbriefe or Public Pfandbriefe respectively. Most Pfandbriefe are issued in the form of bearer bonds, followed by registered bonds.



The Pfandbrief Bank grants property finance, ship loans, aircraft loans and public-sector loans. These assets are reported in the credit institution's balance sheet. The cover pool monitor enters loans or parts of loans that are eligible as cover under the Pfandbrief Act into the respective cover register – together with the collateral for them – which the cover pool monitor watches over. A separate register is maintained for each loan type. In their entirety, the cover assets entered in one cover register are referred to as the cover pool. Pfandbriefe are issued on the basis of the cover pools. The Pfandbrief Bank undertakes to pay the Pfandbrief bearers the promised interest and, at maturity, to repay the principal amount of the Pfandbrief. In the event of the Pfandbrief Bank's insolvency, the Pfandbrief bearers have a preferential claim in respect of the assets entered in the cover registers. The cover pools and the Pfandbriefe are not included in the insolvency proceedings under the insolvency administrator, but are managed separately by the cover pool administrator.

The legal basis for issuing Pfandbriefe is the Pfandbrief Act (Pfandbriefgesetz, PfandBG), the purpose of which is to ensure the Pfandbrief's high standard of safety. On the one hand, this piece of legislation serves to satisfy the demand by certain circles of investors for a secure investment. On the other, thanks to the low risk premiums to be paid, Pfandbriefe provide issuers with a very cheap and reliable source of funding. This in turn enables the issuers to supply the credit market with loans on a continuous basis at prices that take their bearings from the capital market.

The high standard of safety the Pfandbrief offers is owed to the provisions of the Pfandbrief Act and to the regulations issued in connection with the Pfandbrief Act, the main elements of which are as follows.

Supervision

Granting the License

Pfandbrief business, which is to say the issuing of covered bonds on the basis of real estate mortgages, ship mortgages and aircraft mortgages as well as claims acquired against the public sector, is a line of banking business. To be awarded a license to engage in Pfandbrief business, a credit institution must fulfill special requirements. For example, it must have core capital of at least € 25 million and be licensed to conduct lending operations within the meaning of the German Banking Law (Kreditwesengesetz, KWG). Moreover, the credit institution must

- have at its disposal suitable procedures and instruments for managing the risk entailed in the cover pools on the one hand and its issuing operations on the other,
- prove that it intends to engage in Pfandbrief business on a regular and sustained basis, and
- put the appropriate organizational structure and resources into place.

In stipulating these special conditions for the granting of a license, legislators seek to ensure that each credit institution conducts its Pfandbrief business seriously and in a sustained manner by linking the assumption of Pfandbrief business with substantial effort on the bank's part. This is intended to make it more difficult to engage in opportunistic, short-term business strategies.

Because a Pfandbrief Bank needs a separate license for each of the Pfandbrief categories, it must prove it has the requisite expertise in the various operations eligible as Pfandbrief cover.

Under the 2010 amendment, a highly significant new provision was included in § 2 par. 4 of the Pfandbrief Act, whereby the Pfandbrief Bank is to retain its banking license in respect of the cover pools, even if it is revoked for the remainder of the bank (for further details, see the section "Separation Principle in the Event of the Pfandbrief Bank's Insolvency", p. 18 ff.).

Permanent Supervision and Cover Audits

In addition to general banking supervision, a Pfandbrief Bank is subject to a special form of supervision by the Federal Financial Supervisory Authority (BaFin), the aim of which is to monitor observance of the Pfandbrief Act and the regulations issued in connection with it. The permanent supervision is conducted by the department at BaFin responsible for the respective credit institution. The prerequisite for the Pfandbrief market to function effectively is the highest and the most uniform standard of safety possible, across all issuers. For this reason, the special supervision of Pfandbrief Banks must be conducted according to uniform principles. The "Pfandbrief Competence Center – Basic Issues and Cover Audits at Pfandbrief Banks"

was set up at BaFin to ensure the uniform application and interpretation of the Pfandbrief Act. Besides the ongoing supervision, a further feature is the cover audits, which are performed at regular intervals of, usually, two years. Their purpose is to examine the cover pool assets by way of random checks, and they are conducted or monitored by the “Pfandbrief Competence Center” at BaFin to make sure that uniform standards and requirements are complied with.

The 2014 amendment to the Pfandbrief Act laid the foundations for an additional Pfandbrief reporting system whose purpose is to cover the financial position of the cover pools. This ensures that BaFin has the authority and the skills it needs, also in the event that a Pfandbrief bank is subject to supervision by the ECB. The details of this new reporting system still have to be set out in a separate regulation.

In keeping with the supervisory authority’s powers to demand a higher level of capital (capital add-on), BaFin can, moreover, impose a “cover add-on”. This represents a valuable addition to the current 2 % minimum over-collateralization. For each cover pool, BaFin will then separately examine whether the statutory minimum over-collateralization of 2 % appears sufficient; if not, it can then use an administrative act to stipulate additional cover. Such examinations and stipulations would have to take place on a regular basis, within the framework of specific supervision relating to Pfandbriefe and cover pools.

Cover Pool Monitor

Cover pool monitors are to be appointed at every Pfandbrief Bank. Their task is to see to it that the statutory cover for the Pfandbriefe is given and that the cover assets are duly entered in the respective cover register. Appointed by BaFin, cover pool monitors are not answerable to the bank, the supervisory authority or the Pfandbrief creditors. The function they perform is shaped solely by law. BaFin may revoke the appointment for an objective reason. Thus, the cover pool monitor may be regarded as an independent monitoring body.

Under the 2010 Pfandbrief Act amendment the liability of the cover pool monitor was restricted, in the event of gross negligence, which cannot be precluded or limited by way of a contract, to € 1 million (§ 7 par. 5 sentences 2 and 3 Pfandbrief Act. For the first time, this enables the cover pool monitor to take out insurance in respect of his duties.

Quality of the Cover Assets

Not all the loans a Pfandbrief Bank extends are eligible as cover for Pfandbriefe. The Pfandbrief Act expressly stipulates which loans and other claims may serve as cover assets. In this context a distinction is, as a rule, made between the individual Pfandbrief types.

Mortgages as Cover Assets

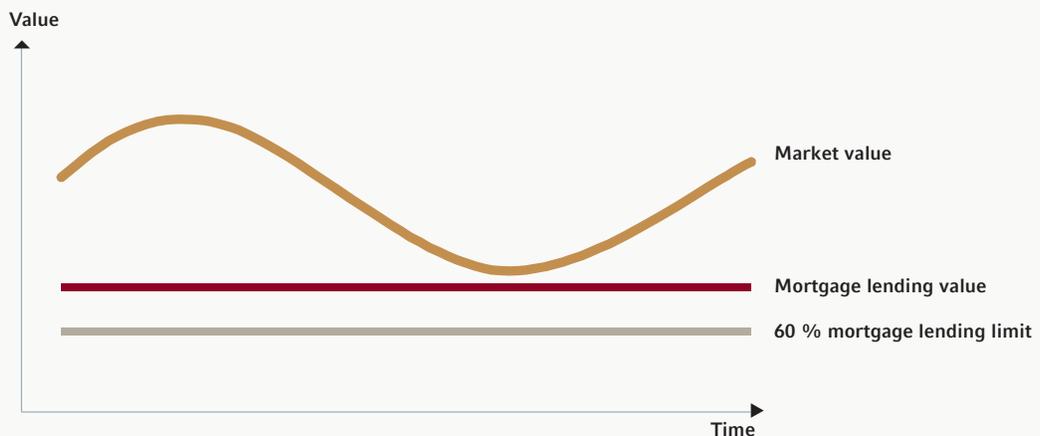
Only mortgages that meet certain requirements may be used as cover for Mortgage Pfandbriefe. Land charges and foreign security interests that offer comparable security rank equal with mortgages.

The property charges may encumber landed property or equivalent titles to land in Germany, in the Member States of the European Union or another Contracting State to the Agreement on the European Economic Area (EEA), in Switzerland, in the USA, in Canada or in Japan; under the 2014 Pfandbrief Act amendment, Australia, New Zealand and Singapore were included in the group of countries. Both commercial and residential properties may be lent against. Also eligible as cover for Pfandbriefe are assets which other credit institutions hold for the Pfandbrief Bank on a fiduciary basis, provided the Pfandbrief Bank is entitled to the sepa-

ration of these assets from the trustee's assets in the event of the latter's insolvency. In order to support securitization and Pfandbrief business, rules were created in 2005 with the Funding Register Law (Refinanzierungsregisterverordnung) under the German Banking Act which ensure the insolvency remoteness of land charges held on a fiduciary basis.

For the Pfandbrief Banks' cross-border business that is eligible as cover, moreover, the share of the loans in respect of which the preferential right in insolvency is not ensured must not exceed 10 % of the mortgage cover assets. The EU Member States are not included in the Pfandbrief Bank's cross-border business in this context, as the preferential right in the case of insolvency is ensured by statutory provisions at EU level.

Mortgage lending value vs. market value



Conservative valuation of real estate

- The mortgage lending value (MLV) is determined according to detailed statutory provisions
- Based on permanent features of the property
- Market value is the upper limit for the MLV
- Occasion-related review of the MLV
- Claims up to 60 % of the MLV are eligible as cover

One of the central pillars of the safety of the Mortgage Pfandbrief is that property financings may be included in cover only up to the mortgage lending limit of 60 % of the mortgage lending value (MLV). The way in which the MLV is to be determined, and the requirements in respect of the valuer's qualifications and the valuer's independence vis-à-vis the Pfandbrief Bank are regulated in detail by the Pfandbrief Act and the Regulation on the Determination of the Mortgage Lending Value (BelWertV). The MLV reflects only the long-term, sustainable aspects of a property, meaning that speculative aspects are disregarded. The aim here is that the MLV, unlike the market value, shows as little in the way of fluctuation as possible. The MLV must not exceed, and indeed is usually lower than, the market value. However, the difference between the two values does not remain constant, for which reason it is not possible to make a simple value deduction. Instead, the difference is determined by the expectations of the market with respect to the future price development of the property in question. Yet the mortgage lending limit of 60 % of the MLV does not mean that a loan, to be eligible as cover, may only be equivalent to this 60 % limit. Only the part of the loan that serves as cover may not exceed this limit. This can be achieved by dividing the loan into two parts – one up

to the 60% limit and the other above it. However, this is not necessary in practice as an ideal division is possible and is applied in most cases.

Finally, the properties lent against must be insured against the risks relevant to the location and type of property concerned.

Claims against Government Bodies as Cover Assets

Under § 20 Pfandbrief Act, money claims resulting from the granting of loans, from bonds or from a comparable legal transaction may serve as cover for Public Pfandbriefe. In particular, debtors in this respect may be

- EU Member States, Contracting States to the Agreement on the EEA and their sub-sovereign bodies (local authorities and regional governments)
- the so-called third states (Switzerland, Japan, Canada and USA) and their sub-sovereign bodies, provided they are assigned to credit quality step 1;
- German public-sector authorities for which state support (“Anstaltslast”) or a legally founded obligation (“Gewährträgerhaftung”) or a state refinancing guarantee has been given, or which are legally entitled to raise fees, rates and other levies;
- so-called public-sector entities of an EU or EEA Member State; public-sector entities of a third state provided they are assigned to credit quality step 1;
- export credit agencies (ECAs) domiciled in an EU/EEA Member State provided the agency meets the requirements to be fulfilled by a “public-sector entity” as defined in Art. 4 (8) of the Capital Requirements Regulation (CRR) (575/2013); following the 2014 Pfandbrief Act amendment, the geographical scope of application of the group with regard to sovereign guarantees has been brought into line with those with regard to direct claims against the sovereign (§ 20, par. 1 sent. 1 no. 2 Pfandbrief Act), so that ECAs from eligible third states may also qualify as guarantors;
- the European Central Bank as well as multilateral development banks and international organizations within the meaning of the CRR (575/2013) (quality step 1 required);
- the central banks of the above EU Member States which meet cover eligibility criteria as well as – to a limited extent – suitable credit institutions in accordance with § 4 par. 1 sentence 2 no. 3 of the Pfandbrief Act

Under the rules set forth in the EU CRR (575/2013), credit quality step 1 is the highest quality category with regard to capital adequacy; this in turn has an effect on the favorable weighting given to the Pfandbrief.

As from July 2005, claims against public-sector credit institutions for which no legally founded obligation or only modified state support exists are no longer eligible as cover. In particular, this concerns savings banks and Landesbanken. However, they may be included in cover to a limited extent as claims against credit institutions. Claims against the above debtors remain eligible as cover if, under the agreement between the German Federal Government and the European Commission of March 22, 2002, they continue to be state-guaranteed (grand-fathering).

Also in the case of claims against public-sector bodies, as with mortgage claims, the 10 % limit applies to claims against debtors from third states in which the Pfandbrief creditors’ preferential right in insolvency is not ensured.

Following the SRM Transposition Act (SRM-Anpassungsgesetz) of 2015, the provision contained in § 20 on the 10% limit has been adapted to meet the requirements specific to government-guaranteed export credit loans.

Ship Mortgages as Cover Assets

Certain ship mortgages may be included in cover for Ship Pfandbriefe (§ 21 Pfandbrief Act). The ships and ships under construction that are lent against must be recorded in a public register. The ships must not be more than 20 years old. Loans against ships, like loans against properties, may be included in cover only up to the equivalent of 60 % of the ship's MLV. The MLV, which is also a permanent value, must be determined according to the principles of the Regulation on the Determination of the Mortgage Lending Values of Ships and Ships under Construction ("Schiffsbeleihungswertermittlungsverordnung"). Special requirements apply to the eligibility of ship mortgages as cover, such as maximum lives for ship mortgages. The share of loans outside the EU in the case of which the preferential right in insolvency is not ensured may not exceed 20 % for Ship Pfandbriefe. This takes into consideration the fact that ships are often registered abroad, and a 10 % limit would unreasonably restrict the use of the Pfandbrief for credit institutions – and with that, their competitiveness.

Aircraft Pfandbriefe

The introduction of § 26a-26f under the 2009 amendment of the Pfandbrief Act is an important new aspect for business qualifying as cover for Pfandbriefe in that loan receivables secured by aircraft mortgages are eligible as cover for a new Pfandbrief category, the "Aircraft Pfandbrief". As is the case with Mortgage Pfandbriefe, Public Pfandbriefe and Ship Pfandbriefe, a separate cover pool is set up for Aircraft Pfandbriefe. As a security interest, the registered lien in respect of an aircraft is of the same high quality and level of reliability as the ship mortgage. The secondary markets for aircraft are liquid and efficient, so that the realization of aircraft is assured. Modeled closely on the rules governing cover assets for Ship Pfandbriefe, the law sets stringent standards both with regard to the collateralization of the loans and to the valuation of the individual aircraft. Thus, the Aircraft Pfandbrief, too, offers the same high level of protection afforded German Pfandbrief creditors.

Claims against Credit Institutions

Claims against suitable credit institutions may serve as further cover assets for all four Pfandbrief types. This serves the purpose of enhancing the cover pool liquidity. The cover pools are made up of a large number of assets with different lives, interest rates and currencies. The lives, coupons and currencies of the Pfandbriefe cannot match exactly those of the cover pools. Usually, for example, Pfandbrief issues are of a greater volume than the underlying assets. To balance out these mismatches it is necessary to be able to include liquid and flexible assets such as claims against credit institutions in the cover pools. Since the basic features of the cover pools should not, however, be changed, claims against credit institutions may account for only up to 10 % of the total volume of each Pfandbrief type. Furthermore, claims against one credit institution are limited to 2 % of the Pfandbriefe.

The 2009 amendment brought with it a change to § 4 par. 1 sent. 2 no. 3 Pfandbrief Act in that the credit quality step 1 was introduced for claims against credit institutions as a quality-enhancing criterion. Further, the eligibility as cover of such claims against credit institutions is restricted to credit institutions in countries which generally speaking belong to the circle of eligible countries. It was made clear, moreover, that loans with a subordination agreement are not eligible as cover. These restrictions apply through the provisions set forth in § 19 par. 1 no. 2, § 20 par. 2 no. 2, § 26 par. 1 no. 3 and § 26f par. 1 no. 3 Pfandbrief Act to all Pfandbrief types, as these provisions refer in this context to § 4 par. 1 sent. 2 no. 3 Pfandbrief Act.

Claims Resulting from Derivative Contracts

Subject to certain conditions, claims resulting from standardized master agreements in respect of derivative transactions against suitable credit institutions, financial services institutions, insurers and central counterparties at a stock exchange, at the German Federal Government and with Federal States (“Bundesländer”) may be eligible as cover for all Pfandbrief types (§ 19 par. 1 no. 4, § 20 par. 2 no. 3, § 26 par. 1 no. 5 and § 26f par. 1 no. 5 Pfandbrief Act).

The natural mismatch (above) between cover pools and Pfandbriefe can give rise to interest rate and currency risks in the cover pools. These risks can be neutralized by offsetting assets, or by derivatives (interest rate and currency swaps) concluded between the Pfandbrief Bank and the derivative counterparty. The net present value of derivatives may change in the short term, depending on how interest and exchange rates develop. A positive value from the Pfandbrief Bank’s viewpoint gives rise to a claim on the part of the Pfandbrief Bank against the counterparty. A negative value means the Pfandbrief Bank has a liability towards the derivative counterparty which, however, is not payable until the derivative contract is terminated. Claims and liabilities are netted against each other on a daily basis. The standardized agreements used in practice for derivatives provide that, in the event of insolvency, either party may terminate the contract vis-à-vis the other with immediate effect. In consequence, the derivatives concluded under the master agreement are settled at their net present value and the resultant claims to which the parties are entitled are offset against each other to establish the net claim.

Such a consequence would not, however, be consistent with the Pfandbrief safety concept, under which Pfandbriefe outstanding may not become payable prematurely – even in the event of the Pfandbrief Bank’s insolvency – but are to be satisfied out of the payment flows from the cover assets when they mature (see “Separation Principle in the Event of the Pfandbrief Bank’s Insolvency”, p. 18). In the event of the Pfandbrief Bank’s insolvency, if the counterparty were able to terminate the derivatives concluded in order to hedge against interest rate and currency risks, the cover pools would be exposed to these risks. For this reason, it is both necessary and required by law that derivatives included in cover may not be terminated by the counterparty if the Pfandbrief Bank becomes insolvent. To achieve this in practice, individual agreements are concluded under a master agreement and derivatives are allocated to the respective individual agreements. For example, if a Pfandbrief Bank issues Mortgage Pfandbriefe and Public Pfandbriefe, three individual agreements may be concluded: one each for the derivatives pertaining to the respective cover pool, and one which covers the remaining assets of the Pfandbrief Bank. Netting takes place only among the derivative claims that fall under the same individual agreement. In the event of the Pfandbrief Bank’s insolvency, therefore, only the individual agreement concluded with the counterparty for the other assets of the Pfandbrief Bank can be terminated. The individual agreements for the cover pools, on the other hand, must remain in force, and could only be terminated if the respective cover pool also became insolvent.

The individual derivatives are entered in the respective cover registers. Derivatives may have a negative value, giving rise to liabilities in respect of the cover pool. As a concession for the fact that the counterparties have to waive their right to terminate the derivative contracts, even if the Pfandbrief Bank becomes insolvent, their claims rank equal with those of Pfandbrief creditors. To prevent the cover pools from becoming inordinately volatile and in order not to undermine the principle behind the cover pools, the claim or the liability under the net derivative position in each cover pool may not exceed – calculated in terms of the net present value -12 % both of the cover assets and of the Pfandbriefe outstanding.

Cover Register

The above-mentioned cover assets must be entered in cover registers (§ 5 Pfandbrief Act). A separate register is to be maintained for each Pfandbrief type. The entry of derivatives is subject to approval by the derivative counterparty and the cover pool monitor. This requirement reflects the above-mentioned special aspects regarding derivatives as cover assets. The cover registers, which may also be kept electronically, must be passed on to BaFin at regular intervals, where they are stored.

Cover registers are, of course, highly important. All the assets recorded in one cover register belong to the respective cover pool and are, in the event of the Pfandbrief Bank becoming insolvent, subject to the cover pool administrator's right of management and disposition. Details on the maintenance of the cover registers are set forth in the Cover Register Statutory Order (Deckungsregisterverordnung).

Active Administration of the Cover Pools to Ensure Matching Cover

The cornerstone of the safety of the Pfandbrief is the fact that the Pfandbrief creditors' entitlement against the Pfandbrief Bank to payment is secured by the cover pools which, in the event of the Pfandbrief Bank's insolvency, are to serve primarily to satisfy the Pfandbrief creditors' claims. Thus it is essential that, should insolvency occur, the cover pools contain sufficient cover assets to satisfy the Pfandbrief creditors' claims punctually. This is achieved, first of all, in that the nominal value and the net present value of the Pfandbriefe outstanding are covered at all times by matching cover pools (§ 4 Pfandbrief Act).

The Net Present Value Regulation (Barwertverordnung) stipulates in detail how the net present value is determined, and permits three methods for calculating the net present value. These methods use different fictitious changes of interest rates and exchange rates which are to be taken into account when determining the net present value. The cover pools are subjected to defined stress scenarios, so that in effect a net present value cover surplus results. Moreover, excess cover must be maintained in net present value terms which amounts to 2 % of the Pfandbrief liabilities to be covered, and which must be invested in particularly liquid assets. The purpose of this mandatory overcollateralization is, in the event of the Pfandbrief Bank's insolvency, to cover risks that may arise as well as administrative expenses payable, and to meet liquidity management costs. Over and above this, it is at the issuer's discretion to maintain further excess cover. Most rating agencies stipulate this as a precondition for awarding top ratings to Pfandbriefe.

Unlike those for Mortgage Backed Securities, cover pools for Pfandbriefe are dynamic. This means their composition changes over time, depending on the maturities and the assets that are newly registered and included in cover. Loans are repaid or are removed from the cover for other reasons, to be replaced by new loans, and new lending is included in cover to enable the Pfandbrief Bank to issue new Pfandbriefe. Thus, the cover pools have to be actively administered to assure matching cover at all times. The Pfandbrief Act stipulates that risk manage-

ment systems must be installed to identify, assess, control and monitor the relevant risks such as counterparty risks, interest rate, currency and other market price risks, operational risks and liquidity risks (§ 27 Pfandbrief Act).

§ 27 of the Pfandbrief Act covers the general handling of different risks inherent to the cover pools. Whereas specific limits are stipulated for interest rate, currency and credit risks, the liquidity risk had originally not been explicitly addressed. Liquidity risk is defined here as the risk that, in the event of the Pfandbrief Bank's insolvency, the cover pool will be unable to provide sufficient liquidity to ensure the timely servicing of the Pfandbriefe maturing in the months to follow, e.g. large-volume Jumbo Pfandbriefe. Rating agencies and investors saw in the absence of a provision dealing explicitly with this possibility a weakness in the Pfandbrief Act, occasioning rating agencies to call for excess overcollateralization to cover this liquidity risk.

Against this background, under the 2009 amendment a new provision to limit the short-term liquidity risk was added (§ 4 par. 1a Pfandbrief Act). Accordingly, the maximum cumulated liquidity need of the next 180 days¹⁾ must be secured by assets that can be used as excess overcollateralization, as well as other liquid cover assets. Liquid assets are considered to be all the financial instruments entered in the cover register which the European System of Central Banks (ESCB) has classified as being eligible for central bank credit (ECB-eligible assets). Various limits do not apply to such assets that are entered in the cover register solely to manage liquidity.

■ Transparency of the Cover Pools

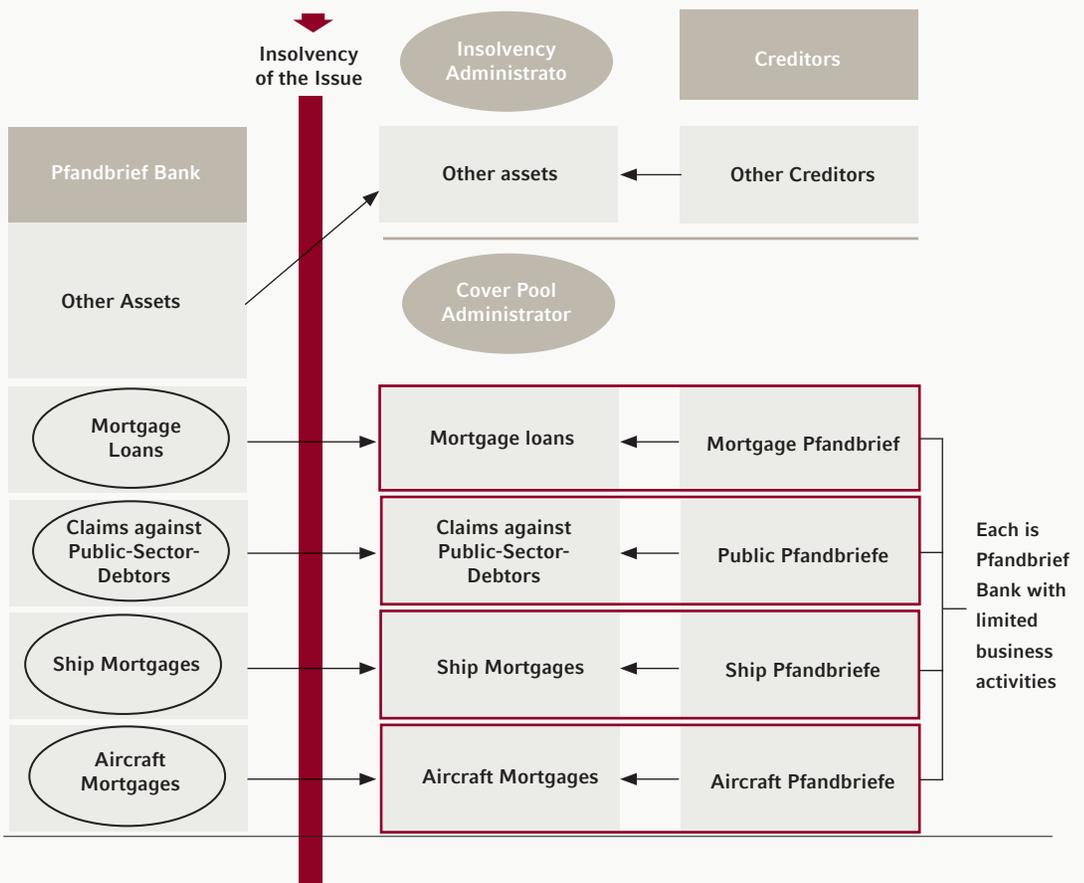
To give investors as exact and up-to-date a picture as possible of the composition of the cover pools and the Pfandbriefe outstanding, Pfandbrief Banks are required to publish certain information on a quarterly basis and additional data annually. Such information includes, for instance, the regional distribution of the cover assets, the type of properties lent against, the debtors of public-sector liabilities and the amount of claims that are at least 90 days in arrears. This allows Pfandbrief creditors to compare the cover pools of different Pfandbrief Banks. The 2010 amendment of the Pfandbrief Act provided for a period of one month after the end of each quarter. The quarterly report must be published within this one-month period; this period will be extended to two months for the fourth quarter.

¹⁾ Der Gesetzentwurf sah ursprünglich einen Liquiditätspuffer von 90 Tagen vor (BT-DS 16/11130 v. 1.12.2008, S. 30). Da dies im Laufe der Finanzkrise als zu wenig empfunden wurde, hat der Bundestag auf Vorschlag des ZKA diese Reserve auf 180 Tage erhöht.

Separation Principle in the Event of the Pfandbrief Bank's Insolvency

A key component of the safeguarding mechanisms enshrined in the Pfandbrief Act are the provisions contained in § 30 ff. Pfandbrief Act, which regulate what happens to the cover pools and Pfandbriefe in the event of the issuer's insolvency. Under this preferential right the cover pools are at the disposal in the first instance of the Pfandbrief creditors and, under certain circumstances, of the derivative creditors in the event of the Pfandbrief Bank becoming insolvent, to satisfy their claims. This means that the Pfandbrief Bank's insolvency does not affect them. To ensure this preferential right, the Pfandbrief Act provides for an "emergency plan" that is set forth in detail. This is also to apply if, under the German Restructuring Act, a bridge bank is involved (§ 36a Pfandbrief Act).

Insolvency Privilege of Pfandbrief Holders



Separation principle in the event of a Pfandbrief Bank's insolvency

- no acceleration of Pfandbrief
- Pfandbrief and cover assets do not fall into the insolvency estate
- Pfandbrief Bank with limited business activities
- Cover pool administrator manages cover assets

Ring-Fencing of the Cover Pools

The cover pools do not participate in the insolvency proceedings in respect of the bank's assets. They form for each Pfandbrief category issued by the credit institution a special (ring-fenced) part of the Pfandbrief Bank out of which the Pfandbrief creditors' claims are to be satisfied, (§ 30 par. 1 Pfandbrief Act). The bank's insolvency administrator therefore has no access to the cover pools and the Pfandbriefe do not accelerate. With regard to mortgage loans, which are in part included in the cover pools and are in part outside the cover pools, the Pfandbrief Act provides that the payment flows from these loans first pass in full to the cover pool administrator (see below). The insolvency administrator can demand that the payment flows be separated at his expense, and that the payments in respect of the parts of the loans above the cover limit flow to him.

Pfandbrief Bank with Limited Business Activities

One question repeatedly asked concerns the legal nature of the cover pools in the event of a Pfandbrief bank's insolvency. The answer sometimes given is that the cover pool is separated from the insolvency estate for insolvency law purposes and given the term "Sondervermögen". This, in turn, is often misunderstood to the effect that the cover pool becomes a SPV, so that the character of a bank (and therefore the banking license) is lost.

In 2009, the German Federal Government, during a so-called small parliamentary interpellation, cleared up this misconception. In its reply (Bundestag printed paper 16/13823 of July 21, 2009, no. 2) the government describes the term "Sondervermögen" as unsuitable and instead uses the expression "besonderer Teil der Pfandbriefbank" (special part of the Pfandbrief Bank) to convey the fact that the cover assets and Pfandbriefe administered by the cover pool administrator together constitute a part of the bank's assets in its own right.

The 2010 amendment of the Pfandbrief Act developed this legal notion further in that the explanatory memorandum to the bill (Bundesrat printed paper 155/10 of March 26, 2010, p. 76f) clearly states that, in the event of a Pfandbrief Bank's insolvency, a cover pool does not constitute a legal entity but remains a special part of the Pfandbrief bank for which the term "Pfandbrief bank with limited business activities" ("Pfandbriefbank mit beschränkter Geschäftstätigkeit") is to be used – separately for each Pfandbrief category. Moreover, it is to be stipulated under the new § 2 par. 4 Pfandbrief Act that the banking license will be retained for the cover funds, even if it is revoked for the rest of the bank.

Cover Pool Administrator

When insolvency proceedings are initiated in respect of the bank's assets, the court at the Pfandbrief Bank's seat appoints one or more cover pool administrators at the request of the supervisory authority (§ 30 par. 2 Pfandbrief Act). Cover pool administrators may also be appointed before insolvency proceedings are initiated if the bank's imminent insolvency is to be feared and such action is necessary to protect the Pfandbrief creditors. The cover pool administrator is a natural person. He has the right to manage and dispose of the cover pools, and represents the Pfandbrief creditors' interests. The creation of the office of cover pool administrator strengthens the protection of the Pfandbrief creditors. It would be inappropriate if the management board of the insolvent bank or bank at risk of insolvency were allowed to continue maintaining the cover pools. Given the conflicting interests of the Pfandbrief creditors and the Pfandbrief Bank's other creditors, the insolvency administrator would likewise be unable to safeguard the Pfandbrief creditors' interests in the appropriate manner.

A number of alternatives are available to the cover pool administrator to ensure that the Pfandbrief creditors' claims are satisfied in a timely fashion:

- He can take the payment flows of the cover pools and service the outstanding liabilities in accordance with the terms of issue. In particular, he may sell individual assets in order to procure liquidity and use a funding register for this purpose. This form of settlement would be continued until all the Pfandbriefe were repaid. Any surplus would be passed to the insolvency administrator.
- As a result of the 2009 amendment, § 30 par. 2 sent. 5, 2nd half-sentence Pfandbrief Act explicitly states that he may take up a refinancing loan in order to procure liquidity.
- In the explanatory memorandum to the 2010 amendment (Bundesrat printed paper 155/10 of March 26, 2010, p. 77) clearly states that the general clause-like description of the cover pool administrator's powers and competences also include the issuance of bonds. In the absence of provisions governing rank, such bonds would rank equal with Pfandbriefe issued prior to the nomination of the cover pool administrator, meaning they would constitute covered bonds of Pfandbrief quality. Thus, the new provision set forth in § 2 par. 4 Pfandbrief Act provides the basis on which the cover pool administrator could issue such bonds under the name "Pfandbrief".
- Following the 2009 amendment, § 31 par. 8 Pfandbrief Act explicitly states that the cover pool administrator is entitled to make use of the Pfandbrief Bank's staff and materials, and that he must refund to the insolvent estate only the costs actually incurred in this respect.
- The cover pool administrator has access to all payments that are made in respect of the cover assets; the insolvency administrator must ensure such access by cooperating with the cover pool administrator (see also § 31 par. 7 Pfandbrief Act). This also applies to amounts or partial amounts which pertain to parts of loans included in cover which are not eligible as cover for Pfandbriefe. The cover pool administrator must hand over such amounts to the insolvency administrator when called upon to do so (§ 30 par. 3 sent. 3 Pfandbrief Act).
- He may transfer all or parts of the cover assets in one cover pool and liabilities under the Pfandbriefe, together, to another Pfandbrief Bank, subject to approval by the supervisory authority (BaFin). In this context, he may agree with another Pfandbrief Bank that he will hold the cover pools on a fiduciary basis for that Pfandbrief Bank. Transferring the cover pools in this way rules out the need for complex and time-consuming individual transfers.
- Rating agencies often raise the question of the "insolvency remoteness of the voluntary overcollateralization". A frequent consequence of the stress tests they apply for the timely servicing of Pfandbriefe is that a Pfandbrief Bank must maintain overcollateralization exceeding the legally required 2 %. In this connection, to question the insolvency remoteness of this "excess cover" is to ignore the fact that, within the scope of these stress tests, such excess cover would automatically be part of the legally required cover. If a rating agency does not believe that the cover assets are absolutely sound and therefore calculates

what overcollateralization is required, then logically these assets that constitute overcollateralization are not (from the rating agency's viewpoint) "voluntary overcollateralization" at all. Instead, they are part of the (normal) cover, since they are needed (in the rating agency's view) to ensure the Pfandbriefe are serviced on time. They cannot therefore fall within the scope of application of § 30 par. 4 Pfandbrief Act. The German Federal Government rightly points this out in its reply to a small interpellation (see Bundestag printed paper 16/13823 of July 21, 2009, no. 6).

The Federal Agency for Financial Market Stabilisation has, under the Recovery and Restitution Act, been granted the authority to order the transfer of Pfandbriefe and cover assets from a distressed bank. The question as to whether such a transfer may be carried out in a direct manner or whether a cover pool administrator must be appointed for this purpose is regulated by § 36a Pfandbrief Act. At any event, when the cover pool includes claims or collateral located outside of the European Union or the European Economic Area, a cover pool administrator must be involved for such transfer. This is because the transfer must be carried out in accordance with the law of the third country; first, recognition in third countries of orders issued by an authority is less assured than when an order is issued by a legally appointed representative such as the cover pool administrator; second, the contractual trustee agreements with which the Pfandbrief creditors' preferential right in case of insolvency is safeguarded in those third countries are based on the cover pool administrator's instructions.

Insolvency or Overindebtedness

Where there is a reason for insolvency with regard to the cover pools, separate insolvency proceedings can be instituted in respect of them at the supervisory authority's request. If the Pfandbrief creditors are not fully satisfied under this procedure, they can assert their remaining claims within the scope of the insolvency proceedings over the Pfandbrief Bank's other assets. Under the 2010 amendment of the Pfandbrief Act, § 30 par. 6 Pfandbrief Act was supplemented accordingly, enabling the cover pool administrator to take the requisite action.