Asset-backed securities in Germany: the sale and securitisation of loans by German credit institutions

Recently, some sectors of the banking industry have been calling more insistently for a supervisory regulation of the sale and securitisation of loans. Since there are unlikely to be harmonised arrangements within the European Union in the near future, the Federal Banking Supervisory Office has now announced to credit institutions its requirements for the off-balance-sheet securitisation of loans. The present article outlines the basic features of this form of funding and explains the supervisory requirements to be met by the credit institutions. It remains to be seen to what extent the German universal bank system will use this form of funding, which has been well established abroad for some time.

Structure and objectives of asset-backed securities transactions

Main features

An asset-backed securities transaction involves a credit institution selling parts of its loan book to a special-purpose vehicle (SPV), i.e. a vehicle which had been expressly set up for a particular transaction or more than one transaction of this kind. The SPV then funds its holdings by issuing asset-backed securities. A special form of asset-backed securities (ABS) – the form in which they originated – are mortgage-backed securities (MBS), which are based on mortgage loans. The ABS are serviced from the payment flows resulting from the payment of interest and principal on the loans sold to the SPV. Assets which are

particularly suited to securitisation are those evidencing claims on a large number of borrowers and having a high degree of homogeneity at constantly low default rates and a low ratio of late interest and principal payments due. As a rule, the assets sold continue to be serviced by the selling bank on the basis of an agency agreement with the SPV. A trustee monitors the appropriateness of the asset management and protects the interests of the ABS investors. An essential feature of the ABS constructions is that the credit quality of the paper issued is separated from the credit quality of the selling bank; particular assets which are transferred to the SPV are made legally autonomous in such a way that they serve the buyers of the ABS as the main instrument securing their claims. In contrast to the mortgage bond, the issuer's credit rating is irrelevant. Various precautions are taken when constructing the ABS (safeguards incorporated in the ABS construction and/or external credit enhancements, such as third-party guarantees) in order to protect the investors against the risk of interest payments and payments of principal not being received on time or against the risk of default. These enhancements are essential for the first-class rating which is needed for a high level of acceptance on the part of investors and for low-cost funding.

Primary purpose

In the first place, ABS transactions are used by the selling bank to obtain liquidity. It can then use the funds received from the proceeds of the asset sale for contracting new business or repaying obligations. The full benefit of such transactions, however, is realised only if the assets are sold in such a way that their removal from the selling bank's balance sheet is justified. The selling institution can thereby improve its balance sheet ratios and gain greater room for manœuvre under legal business constraints. Moreover, ABS transactions can be used to change the risk and cost structures. By performing specific functions in such transactions, credit institutions can, in most cases, earn commissions without incurring any risk. For investors, the advantage lies mainly in the security of the investment and the fact that the yield of ABS tends to be higher than that of other debt instruments while carrying roughly the same risk.

Origin and development so far

Origins in the USA

The emergence and development of asset-backed securities are closely connected with the special features of the US banking system. The first transaction of this kind was the issue of mortgage-backed securities (MBS) in February 1970 by a public law vehicle of the US Housing Ministry. The Government National Mortgage Association (GNMA or Ginnie Mae) had purchased mortgage loans and issued securities on them as part of the creation of a secondary market for mortgage loans and in support of undercapitalised regions. In the ensuing years, the construction of ABS transactions in the United States took on many forms and underwent numerous improvements. Another government body developed what were known as collateralised mortgage obligations (CMOs), in which payment flows were managed for the first time in such a way that the payment of

interest and principal was no longer passed through direct from borrowers to investors. This made it possible to take greater account of investors' preferences by offering them tranches with different maturities.

The use of ABS spread rapidly during the eighties. Both structural changes, particularly the deregulation measures initiated in March 1980, and cyclical factors played a part in this. The Capital Accord of the Basle Committee on Banking Supervision of July 1988[1] likewise encouraged this trend. In a situation where the banks were faced with increased capital requirements, ABS (including MBS) were a means of easing balance sheet constraints, saving capital and obtaining low-cost funds, provided that the banks held appropriate assets. The ensuing trend was marked by the emergence of modified forms of securitisation, such as commercial paper programmes, which were tailored even more closely to investors' specific requirements, and the securitisation of revolving credit. Almost simultanously with developments in the United States, ABS were also used in Europe, namely in France and the United Kingdom. However, market volumes there to date have attained only a vanishingly small fraction of the volume in the United States.

Background of transactions in Germany

In November 1990, the German subsidiary of an internationally operating banking group informed the Federal Banking Supervisory Office of its intention to transfer part of its hire-purchase loan portfolio to an SPV located abroad for the purpose of securitising it with borrowers' notes (to be issued as a private placement). This met with reservations on the part of the Federal Banking Supervisory Office. Although the institution did not comply with the Office's request to refrain from the transaction, which was due for imminent realisation, it dropped its plans to go ahead with a second ABS transaction, which was already in preparation. When the banks became aware of the objections which had been raised by the Federal Banking Supervisory Office in this specific case, other credit institutions, which were about to securitise their own assets, also shelved their plans. Whenever German credit institutions took part in such transactions in the ensuing period, they acted either as the external providers of security, e. g. by providing a guarantee, or as originators or intermediaries and servicers of such transactions in the non-banks sector. It was not until April 1995 that a German credit institution once again sold assets from its own portfolio for the purpose of securitisation. In this case, a mortgage bank transferred subordinated loans totalling DM 523 million, which had brought it to the ceiling prescribed in section 5 (1) 2 of the Mortgage Bank Act, to a foreign SPV, which used these assets to back the issue of debt securities. Following this, other credit institutions, too, advised the Federal Banking Supervisory Office that they likewise intended to securitise assets from their loan portfolios. In that situation, the Federal Banking Supervisory Office was neither able nor willing to wait any longer for a possible harmonisation of regulations governing the securitisation of

1 It prescribed that the total capital of an internationally operating bank was to amount to at least 6½% of its risk-weighted assets by December 31, 1990, 7¼% between January 1, 1991 and December 31, 1992, and 8% by no later than January 1, 1993.

assets by banks within the European Union and, together with the Deutsche Bundesbank, elaborated rules for such financial transactions which were partly modelled on regulations in other countries.

Prudential reservations

Operational viability of the banking industry

Hitherto, there have been no special legal provisions governing the sale and subsequent securitisation of assets by German credit institutions. The supervisory authorities were merely able to examine, pursuant to the provisions of the Banking Act, whether the construction of such transactions, numerous variants of which had already been introduced in international practice, was likely to place the safety of the assets entrusted to credit institutions at risk, adversely affect the orderly conduct of banking business or involve serious drawbacks for the national economy. If the Federal Banking Supervisory Office identifies such undesirable developments in the banking industry, it must use its scope for intervention (section 6 (2) of the Banking Act).

Increased shifting of financial relationships to the non-banks sector

The objections raised by the Federal Banking Supervisory Office in November 1990 were, first of all, based on the fact that this form of funding allows credit volumes to be built up outside the government-supervised banking industry without any major needs of capital, and that in Germany, too, this could promote a trend towards credit institutions being displaced in their role as intermediaries between borrowers and investors (disintermediation).

Disruption of the confidential relationship between bank and customer

Concern was also expressed that the debtors of the assets sold might be placed at a disadvantage compared with those in which the lending bank remains the creditor, and that there might be a lasting disruption of the confidential relationship between customer and credit institutions if the customer learns of a change of creditor that has been made without his knowledge and consent. As a result of such a change, the borrower might suddenly be faced with new creditors which – being non-banks – are not subject to banking supervision and, moreover, generally have their registered office abroad for tax or other reasons.

Impairment of credit quality and moral recourse

In those countries where the sale of assets by banks for the purpose of securitisation has been common practice for some time now, the banking supervisory regulations governing ABS transactions reveal that, in order to achieve a first-class rating for the ABS, the selling bank may be encouraged to sell those assets which have the highest quality and carry the lowest risk, thus leading to a deterioration in the average quality of its remaining loan book. Conversely, credit institutions, bearing in mind the possibility of selling higher-risk loans for the purpose of securitisation, might apply lower standards to their borrowers' credit rating in their lending operations. Moreover, in order to prevent the market from drawing undesirable conclusions as to the quality of its remaining portfolio and notwithstanding contractual non-recourse agreed on the sale of the assets, the selling bank might feel obliged to repurchase assets before recourse is had to an external guaran-

tor if interest and principal payments are not made when due or in the event of default.

Findings to date

Lack of information on the failure of ABS transactions

These frequently-voiced objections run counter to the finding that there is virtually no known instance so far in the United States or in other countries of an ABS transaction having failed. It should be borne in mind, as well, that the market for ABS in the United States is exceptionally large. The average annual volume of sales of ABS in the domestic US market, which attained a record level of around US$ 610 billion in 1993, has now settled down to a level of about US$ 300 billion. The Bank for International Settlements estimates that sales in 1996 amounted to around US$ 340 billion, with MBS accounting for roughly 55 %.[2] Almost US$ 1 ½ trillion of ABS is said to be currently outstanding in the United States. Even the serious crisis of the Savings and Loan Associations, which used MBS on a large scale for funding, has evidently failed to cast any doubts on this form of financing.

Careful planning and implementation

The fact that ABS are considered to be safe and comparatively successful investment vehicles is due to two main factors. Besides the intrinsic value of the paper, as discussed above, the industry points out that the originators and chief participants in ABS transactions are generally well-known large institutions which cannot risk jeopardising their reputation with investors (the majority of which are institutional investors) as a result of even one single failed transaction of this kind. ABS transactions, it is claimed, are always planned, prepared and carried out with very great care.

Statement by the Federal Banking Supervisory Office

Need for supervisory regulation

In response to the increasingly insistent call from some sectors of the German banking industry for a supervisory regulation of ABS transactions, the Federal Banking Supervisory Office has prepared a basic list of requirements to be complied with by credit institutions in securitising their assets, if securitisation is to reduce the capital requirements pursuant to Principle I. The capital which was previously tied up by the assets sold can be freed as intended only if the selling bank is definitely not left with any counterparty or market risks. Whereas legislation governing ABS in other countries mostly deals with all the functions which can be performed by banks in such transactions, the Statement addresses only the credit institution's function as a seller of assets which is problematical for supervisory purposes.[3] Other functions, such as the assumption of bank guarantees, are already covered by existing legislation.

Coordination with the central associations representing the banking industry

The Federal Banking Supervisory Office held a consultation on ABS with the central associations representing the banking industry, the Institute of Auditors and other committees on

2 Bank for International Settlements, International Banking and Financial Market Developments, November 1996, page 36 ff.
3 For the monetary policy implications, see Deutsche Bundesbank, Trends towards securitisation in the German financial system and their implications for monetary policy, Monthly Report, April 1995, page 19 ff.

August 28, 1996 in Berlin. Because of a number of questions pertaining to bank secrecy were still undecided, the Federal Data Protection Commissioner and the committee of experts of the senior supervisory bodies for data protection in the private sector were also in attendance; furthermore, additional comments on individual issues of international practice were invited from foreign experts. At the end of January 1997 a revised draft of a circular letter was once again distributed to the associations for them to comment on. Another meeting was held with representatives of four associations representing the banking industry in Berlin on April 25, 1997 to clarify questions of interpretation raised, in particular, by the Central Credit Committee (the federation of the central associations representing the German banking industry) on the text of the statement adopted by the Federal Banking Supervisory Office in mid-March. The mailing of the circular letter to the credit institutions was postponed until remaining unsettled points were clarified.

Guidelines and reservation of the right to review individual cases

In its circular letter[4], the Federal Banking Supervisory Office informed all credit institutions of its requirements for the sale and securitisation of loans and advances to customers. The covering letter draws attention to the possibility of reaching an agreement with the Federal Banking Supervisory Office on modified arrangements concerning certain points. The Federal Banking Supervisory Office is thereby offering credit institutions reliable guidelines for planning ABS constructions and transactions. If an ABS construction meets the requirements listed in the circular letter, the selling bank can assume that the Federal Banking Supervisory Office will recognise the desired reduction of the capital adequacy requirements under the Principles. Prior consultation with the Federal Banking Supervisory Office is recommendable in all other cases. If there is any doubt, only a review of the individual case will show whether and, if so, which risks will remain with the selling bank. Credit institutions selling assets from their loan book for the purpose of securitisation continue to be subject to the supervisory norms insofar as the risks of loan losses and maturity mismatches remain with them.

Requirements for a transfer of assets which removes asset items from the balance sheet and reduces capital adequacy requirements

The assets to be sold are to be selected at random observing contractually predetermined criteria. The supervisory authorities are thereby seeking to prevent a deterioration in the quality of the remaining loan book associated with the sale. If it becomes apparent that the sale of some of a credit institution's assets has lowered the quality of its remaining portfolio, the Federal Banking Supervisory Office can assume that special circumstances apply within the meaning of subsection (2) sentence 3 of the Preamble to the Principles Concerning the Capital and Liquidity of Credit Institutions, and impose, for example, higher Principle I requirements. The transfer of assets to the SPV must result in a legally effective and non-recourse subrogation. Any rights of recourse to the selling bank, other

4 Federal Banking Supervisory Office, *Veräußerung von Kundenforderungen im Rahmen von Asset-Backed-Securities-Transaktionen durch deutsche Kreditinstitute* (Sale of loans and advances to customers in asset-backed securities transactions by German credit institutions). Circular letter 4/97 of March 19, 1997, distributed to credit institutions in the Federal Banking Supervisory Office's letter (I 3 – 21 – 3/95) of May 20, 1997.

than liability for the legal effectiveness of the claims and compliance with the agreed selection criteria, must be excluded. It is only then that removal of the assets from the selling bank's balance sheet will be warranted. In order to forestall undisclosed repurchases, the exchange of individual assets at a later date is not permitted – with certain exceptions concerning the residual liability of the selling bank, which cannot be excluded contractually. For the closing phase of an ABS transaction, however, an agreement can be made in advance that the selling bank will repurchase a residual amount of less than 10 % of the original asset volume from the SPV for reasons of cost-effectiveness and adequacy. Such a repurchase is subject to the condition that all investors have been fully serviced beforehand and that the repurchase price is based on the market value of the assets.

Neither the selling credit institution nor an enterprise belonging to the group within the meaning of section 10a of the Banking Act may contribute in any way to funding the SPV during the life of the ABS transaction. If the selling credit institution or an enterprise belonging to the group provides the SPV with financial resources in order to enhance its credit rating, this must have been done prior to the transfer of the assets and only in the form of a subordinated loan. The requirement of subordination is intended to create clear financial relationships. In the event of insolvency or liquidation of the SPV, the loan may be redeemed only after all unsubordinated creditors have been satisfied. Moreover, these amounts must be disclosed to investors in the offering prospectus.

Loans granted by the selling bank to the SPV in connection with the ABS transaction which are subject to the above-mentioned conditions have to be deducted in full from the liable capital of the seller or the enterprise belonging to the group. In the discussion, this provision met with considerable resistance from the banking associations. They considered the selling bank's assistance in enhancing the credit rating to be normal risk assets, to which an 8 % capital weighting should be applied. What is crucial for the supervisory authorities, however, is that such loans, as a rule, fully cover the historical rate of actual defaults, evidenced over an extended period, and that the acceptance of such obligations by the selling bank, in principle, contravenes the necessary clear distinction between its business risk and the assets sold. Moreover, an appropriate treatment in accordance with the provisions of Principle I, i.e. applying an 8 % weighting to the total assets sold, would in most cases be the less favourable alternative for credit institutions. It should also be noted that the Federal Banking Supervisory Office is allowing credit institutions to extend credit-enhancing assistance for loans sold from their portfolios only on competitive grounds and by setting aside its basic reservations.

If the selling bank merely grants the SPV a liquidity facility to enable it to take ABS out of the market, as required, and hold them for a short period in its portfolio, this facility has to be counted towards Principle I, however.

Chiefly in the interests of definitely excluding any liability for the issue, the selling credit

institution, when the ABS are placed[5], may not assume any placement risk on its own part, say, as an underwriter, nor purchase any such paper in the primary market for inclusion in its own portfolio. By purchasing in the primary market, the selling bank would become an investor, as it were, which might imply that not enough other investors can be found, i.e. that the transaction is threatening to fail. Furthermore, in the case of a direct purchase, the counterparty and settlement risks would return to the selling bank in a modified form, making it doubtful whether removal of the assets from the balance sheet would be warranted. If a bank buys ABS resulting from the securitisation of its own assets in the secondary market, it may do so only at the current market price, and such purchases must not constitute lending to the SPV or the investors.

Organisation and liability of the SPV

Mainly in order to protect itself against recourse claims after the transfer of the assets if the SPV runs into payment difficulties, and also to avoid any consolidation requirements, the selling bank must have no ties, either as part of a group or under company law, or capital or personal ties with the SPV. The selling bank must not be able to exercise any influence on the management of the SPV. To make it quite clear to outsiders, too, that there is a complete separation, the firm name must not be identical or similar. The SPV (issuer) must expressly point out to the investors in the offering prospectus for the ABS that it is exclusively liable in respect of the investors' claims unless the selling bank has assumed specific responsibilities which have to be disclosed to the investors.

Preserving bank secrecy

Protection of the borrower

Apart from the fact that securitisation of a credit institution's assets must not adversely affect the proper conduct of banking business, the special confidential relationship on which the business relationship between the bank and its customers is based, and which is reflected in bank secrecy, must not be impaired. In principle, the selling bank violates its obligation to preserve secrecy if it discloses to third parties – in this case the SPV – personal data of its borrowers without their consent; the data to be protected comprise all details concerning the creditor-debtor relationship and not just, say, the debtor's name and address. If a bank obtains its customer's consent in connection with an ABS transaction, the customer must be informed of the nature of the transaction and, in particular, of who is provided with what personal data and for what purpose. Furthermore, the borrowers of a bank must also be protected against the risk of their loan being settled in an inappropriate manner following a change of creditors. That would be the case, for instance, if the new creditor were to resort to particularly stringent measures against defaulting borrowers in order to ensure a steady stream of payments for servicing investors.

No problems in the selling bank managing the assets

In order to prevent a disruption or a break-up of the relationship between the bank and its

5 In this connection it should be noted that Deutsche Mark-denominated securities are to be issued through credit institutions located in Germany only. Deutsche Bundesbank, Monetary Policy Regulations, Banking Regulations 3, page 21 ff. (Statement concerning Deutsche Mark issues, July 3, 1992).

borrowers caused by a transfer of the assets to a new creditor, it is the rule that the selling bank, when securitising its assets, continues – as mentioned above – to manage its loan book and collect interest and redemption payments. It is only in this instance that the selling bank is no longer required to obtain the customers' consent to the disclosure of their data in connection with the asset sales.

Safeguards in the case of a necessary disclosure of the debtors' data

The nature of the ABS constructions makes it necessary, however, to disclose certain features of the individual assets to participants in these transactions, such as a trustee, a rating agency or an auditor. The customers' consent to such a disclosure is unnecessary only if their identity is not disclosed to those third parties and if those third parties contractually agree to preserve secrecy. It must also been borne in mind that a legally effective subrogation presupposes that the assets can be identified adequately and that the new creditor is able to enforce his rights in a court of law, if necessary. In that case, the privacy of the borrowers is deemed to be preserved if their personal data are given only in a coded form when the assets are transferred – in line with international practice regarding such transactions – and the decryption code is deposited with a neutral agent, for example. The documentation may then be used in individual cases for enforcing the creditors' rights inside or outside a court of law.

Subsequent change in asset management

Even if the selling bank initially manages the assets, there is no absolute certainty that it will actually perform this function throughout the life of the transaction. The selling bank may, for instance, become insolvent or it might become necessary to revoke its responsibility for collection owing to a violation of its contractual obligations. In such cases, the management of the assets that have been sold must be entrusted to a credit institution which is subject to German banking supervision or to a credit institution supervised in accordance with the EC Banking Directives and having its head office in another member state of the European Union or in another state which is a party to the Agreement on the European Economic Area.

Prudential information

Submission of information memoranda

Given the large variety of possible ABS constructions, it is indispensable for the banking supervisory authorities – at least during the initial phase – to review each individual case, analysing the distribution of risks. For this purpose, credit institutions must inform the Federal Banking Supervisory Office and the Deutsche Bundesbank immediately upon conclusion of a contract for the sale and securitisation of assets from their portfolio and submit to these authorities the principal documents necessary for an appropriate assessment of the construction used. For the credit institutions it is important that this does not constitute an application procedure. However, the Federal Banking Supervisory Office's assessment, on reviewing the documents, may differ from that of the credit institution. The Office may then have to intervene if the credit institution has started the transaction immediately after submission of the documents, even though the ABS construction does not comply in all respects with the

supervisory requirements. Moreover, examination of the documents and the discussions with the credit institutions provide the Federal Banking Supervisory Office with information which is necessary for a future adjustment of the ABS regulations to market developments. Assessing the extent to which the information requirements will have to be retained permanently will be possible only when the banking supervisory authorities have acquired an adequate overview on the basis of their practical experience.

Extended audit requirements

In future, the auditor of the credit institution concerned will have to check, as part of his audit of the annual accounts, whether a securitisation has substantially reduced the quality of the selling bank's remaining loan book. If appropriate, the auditor must comment on this point in his audit report (section 26 of the Banking Act).

Monthly balance sheet statistics

The informative value of the balance sheet statistics provided by the credit institutions for measuring overall liquidity in the economy will be reduced if credit institutions relinquish their role as intermediaries between borrowers and investors to an unidentifiable extent. For the Deutsche Bundesbank it is therefore important to follow the future development of this new type of business in Germany and to monitor the extent to which ABS transactions have an actual impact on the aggregates of the overall monetary survey. For that reason, it is planned that the total book values of the assets underlying the ABS, and managed by the reporting credit institution as a collection agent, are to be reported in the monthly balance sheet statistics, irrespective of whether the assets were sold by the reporting credit institution or by another domestic credit institution.