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Why Germany's Pfandbrief banks can provide mortgage finance even in the worst of times

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For those active in UK "bigger ticket" property finance, a list regularly published by international real estate advisor Savills names the most active lenders, making interesting reading. While the definition of "bigger" ticket varies between £20m to £25m, one constant may come as a surprise: since 2009, the share of German lenders is at least half - and at last count was roughly three-quarters. Even for those in the know, many may be unaware that all these German banks have something in common: they are all Pfandbrief banks; they all regularly issue the oldest of all covered bonds - and that is no coincidence. This is especially remarkable in these days when, as Savills acknowledged in March, "there is less debt financing about." It is the Pfandbrief that puts German banks in a position to provide big ticket mortgage finance when other lenders are unable or unwilling to do so. The Pfandbrief, their indispensable refinancing instrument on the capital markets, is an instrument densely regulated by the law. Legislators have always seen to it that the instrument remained the gilt-edged investment it was invented to be was back in 1769. In the case of mortgage finance that means that only the safest part may be funded. Today's Pfandbrief Act regulations have been amended several times in the last 30 years, increasing the countries where Pfandbrief banks can acquire mortgage loans suitable for cover. But the legal definition of the secure part of mortgage loans has stayed the same since 1900: 60% of the mortgage lending value (MLV) of the property collateral.

In Germany the MLV concept is widely used for property finance purposes. This is a special

characteristic since in most other countries market value predominates. MLV and the market value follow different concepts: market value is meant to reflect the current value of a property at a given point in time. But as many investors found to their dismay, market values as recent as last year's, may come to nothing in today's bearish market. Property is a long-lasting asset, and the MLV accounts for this. It is the value that the property should generate in the event of a sale throughout the life of the lending, ie for many years. The German MLV regulation states that only the long-term sustainable aspects of the property, the normal and local market conditions and the current use as well as appropriate alternative uses may be taken into account. Temporary fluctuations in market value and speculative elements may not play a part when MLV is determined. The law also states that MLV must not exceed the current market value.

While their calculation follows totally different concepts, a comparison between MLV and market value can be revealing. The extent of the differential varies widely, depending on the position in the market cycle and the individual property. When a market is in recession the difference between the two values is sometimes very slight. On the other hand, in the boom phase between 2004 and 2006, MLVs of residential complexes in the USA or retail warehouse parks in the UK were at times more than 40% below their estimated market value. The fact that the MLV determines the amount of funding available through the issuance of Pfandbrief has a two-

fold effect. When market values are way out of line from the MLV point of view, a Pfandbrief bank will have to find other sources of funding for a substantial share of the loan - and might even refrain from granting the loan altogether. But when market prices are closer to MLV, Pfandbrief issuance offers reliable and cheap funding for a considerable amount of the loan. This is why Pfandbrief banks found it hard to provide financing in the boom phase and why they currently fill the ranks of the "big ticket lenders".

In these past months and years of crisis many banks found some refinancing channels, such as MBS issuance, had vanished. Yet even in the worst of times, even when disruptions occur in sovereign debt markets, Pfandbrief issuance is always an option for Germany's Pfandbrief banks and investors, seeking funding for real estate investment. The Pfandbrief enables them to stay active in markets where other providers of property finance had to close shop. There are a number of reasons: The Pfandbrief has never disappointed an investor in more than 240 years of its history - thanks, in part, to the MLV concept. Also, it has a particularly loyal investor base. Some suggest that, being Germany's oldest financial product, it is part of this country's financial DNA. So legislators, Pfandbrief banks and their association will see to it that the Pfandbrief stays what it always was: a secure investment - and a reliable source of funding. ■jt

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