The German securitisation market continues to show strong growth, with the issuance volume rising to approximately €62 million in 2006 due to several jumbo transactions which boosted the league tables. All asset classes similarly benefited from market growth in 2006. In particular, the asset classes of mortgage-backed securities, asset-backed securities and collateralised loan obligations continue to dominate and define the market’s diversification as its most distinctive pillars. The structural transformation on which market observers have been remarking continues to shape the German securitisation landscape. While the securitisation of residential mortgage loans dominates in other European countries, the mortgage-backed securities sector has seen a growth in securitisation of commercial mortgage loans in Germany. To this end, in 2006 German multi-family housing commercial mortgage-backed securities were established as a new asset class in the market segment. Issuance of asset-backed securities, in particular car loans, is also performing strongly. The market has further seen an increase in the number of transactions involving loans to small and medium-sized enterprises in the form of collateralised loan obligations, as well as the securitisation of mezzanine financing for small and medium-sized enterprises. A trend in recent years has been the increasing replacement of formerly predominant synthetic transactions by true-sale structures, and this trend is continuing.

Regulatory framework
The past few years have seen various changes to the German legal framework for securitisation, including:
the introduction of refinancing registration, which creates insolvency-proof access by a special purpose vehicle to the relevant assets of the originator (serving as collateral) in the event of the originator’s insolvency, without requiring a German law transfer of title to such asset; and

the abolition of state guarantees and clarification of changes regarding value added tax and trade tax.

The most important recent change to the legal supervisory framework has been the implementation of the Basel II capital rules, as well as the corresponding EU Capital Requirement Directive, comprising the EU Banking Consolidation Directive (2006/48/EC) and the EU Capital Adequacy Directive (2006/49/EC). The relevant transformation law came into force on January 1 2007, implementing the harmonised standards into German law through amendments to the Banking Act and the regulation governing large exposures and loans of €1.5 million or more, and introducing the new Solvency Regulation.

The German legislature has elected to apply the waiver rule according to Article 69 of the Banking Consolidation Directive, thereby allowing group members of an individual parent institution, subject to the fulfilment of certain conditions, an exemption from individual requirements (Section 2a of the Banking Act).

Germany has also exercised the member states’ election right regarding the exemption of intra-group exposures from risk-weighted exposures and the treatment of exposures to a counterparty which is a member of the same institutional protection scheme under Articles 80(7) and (8) of the Banking Consolidation Directive. Thus, Section 10c of the Banking Act provides, subject to the fulfilment of certain conditions, that the Federal Supervisory Authority may assign a 0 per cent risk weighting to exposures not forming part of the own funds of a credit institution to its parent undertaking, its subsidiary, a subsidiary of its parent undertaking or an undertaking linked by a relationship within the meaning of Article 12.1 of Directive 83/349/EEC. In addition, if certain conditions are met, the Federal Supervisory Authority may assign a 0 per cent

risk weighting to exposures not forming part of own funds to counterparties which are members of the same institutional protection scheme as the lending institution. Both exemptions apply regardless of which approach is chosen to determine the capital requirement.

The German legislature has used the opportunity of amending the Banking Act to adjust the notice obligations regarding the holding of an interest or participation under Section 24 of the Banking Act, after talks between the Financial Supervisory Authority and the credit services sector. The third pillar of Basel II regarding disclosure rules has been inserted as a general clause in Section 26a of the Banking Act, with details set out in the Solvency Regulation.

The increase of regulatory capital for internal ratings-based banks lending to small and medium-sized enterprises should increase funding costs for those entities. Therefore, securitising trade receivables through asset-backed commercial paper programmes may prove an attractive source of funding for them. Asset-backed commercial paper conduits may thus expect strong activity in this sector. Owing mainly to the change in the risk weighting for the underlying asset classes in both the standardised approach and the internal ratings-based approach, capital requirements before securitisation will match the banks’ needs for economic capital much more closely. The new legal supervisory framework is expected to curb the incentive to reduce regulatory capital requirements by securitising exposures (ie, regulatory capital arbitrage), as high-grade or retail assets will attract a lower level of regulatory capital if a bank retains them on the balance sheet. However, they may be used as collateral for on-balance sheet financings (eg, covered bonds, structured covered bonds or other types of collateralised issuance or secured funding). Indeed, regulatory treatment of covered bonds, structured or plain covered bonds are addressed through the Capital Requirements Directive. Basel II risk weightings for (structured) covered bonds will now be determined by reference to the bank issuing the covered bonds, rather than by reference to the legal or structural protection of the covered bonds themselves.
Recently, the German structured covered bond market has seen an offering of covered bonds that fall outside the Pfandbrief Act (covered bonds), backed by a pool of assets consisting of residential mortgages loans originated by German saving banks and secured loans granted to German saving banks. The transaction used structuring techniques designed to ensure that the cover pool is ring-fenced in the unlikely event of the insolvency of the sponsor. Similar to BNP Paribas’s issuing of French covered bonds outside the French law governing obligations foncieres (mortgage bonds), it adds to the trend of issuing bonds with similar characteristics to those issued under the Pfandbrief Act (e.g., full recourse to issuer), while at the same time allowing more flexibility, such as including assets in cover pools that fall outside those allowed under the Pfandbrief Act. It also opens up market access to smaller German saving banks which either cannot afford the pricing or are ineligible to issue covered bonds under the Pfandbrief Act.

Tax reform

Germany is anticipating new tax legislation in the near future. In March 2007 the German Cabinet passed a tax reform bill for companies which seeks to implement material changes in 2008. The key theme of the reform is a significant reduction of tax rates, which responds to longstanding demands to make Germany’s profile more attractive for investors. The revenue loss generated thereby will be counterbalanced by a broader tax base. Key elements of the tax reform that are also expected to affect the securitisation market in Germany include the following:

- The average income tax burden on corporations will be reduced from 39 per cent to just below 30 per cent (plus a 5.5 per cent solidarity surcharge);
- Corporate income tax will be reduced from 25 per cent to 15 per cent (plus a 5.5 per cent solidarity surcharge); and
- The effective rate for municipal trade tax will be reduced from approximately 20 per cent to approximately 15 per cent. As is presently the case, the precise trade tax rate will depend on the multipliers established by the local municipalities.

However, municipal trade tax will no longer be deductible as a business expense.

The tax cuts will also extend to the Mittelstand, Germany’s largely family-owned medium-sized businesses. These are usually organised as business partnerships, which are transparent for income tax purposes but not for municipal trade tax purposes. At present, individuals who own an interest in such partnerships are subject to personal income tax at progressive rates of up to 42 per cent (plus the solidarity surcharge) on their share of partnership profits. Individual partners can largely credit their allocable share of trade tax paid by the partnership against their personal income tax. In future, individual partners will pay less personal income tax on undistributed partnership profits; consequently, the aggregate income tax burden (including trade tax, which will remain creditable) on such profits will not exceed 30 per cent (i.e., the average income tax burden on corporations). Upon distribution, the tax advantage against higher progressive tax rates will be recaptured and the final flat tax for dividends will apply.

Interest barrier

The tax bill abolishes the current thin-capitalisation rules (i.e., limitations on the deductibility of interest on related-party loans) and introduces instead the concept of an interest barrier, under which net interest expenses will no longer be deductible if they exceed a certain percentage of earnings before interest and taxes (calculated in accordance with applicable tax provisions). Interest which is non-deductible can be carried forward for deduction at a future time. At the time of writing, the details are still unclear. The interest barrier concept will not allow interest (including interest on third-party loans) to be deductible (but instead must be carried forward) if net interest expenses (i.e., the excess of interest expenses over interest income) exceed 30 per cent of earnings before interest and taxes. However, the concept exempts companies with less than €1 million of net interest expenses.

It is expected that the interest barrier concept will significantly affect financing structures in Germany, in
particular leveraged buy-outs. Regarding securitisations, it will certainly impact on the scope of tax deductability of the interest an issuer pays in a securitisation structure. At present, the reform bill provides for an escape clause under which a German affiliate company may deduct interest in full if the debt-equity proportion of its international group corresponds to its own debt-equity proportion. However, not all securitisation structures will be able to make use of the escape clause. This may be especially true in the case of application of the International Financial Reporting Standards (IFRS) consolidation principles resulting from the application of IFRS accounting principles to the originator. Indeed, its application may lead to the view that, under the accounting perspective of the IFRS ‘risk and reward’ approach, a special purpose vehicle is consolidated to a group.

The legislative reasoning accompanying the reform bill states that a securitisation vehicle is exempt if it is not dominated by a single legal entity. This is an important point which may yet become clearer in the course of the legislative process.

Trade tax
The tax reform bill also abolishes the current add-back of 50 per cent interest on long-term indebtedness to the trade tax base. Instead, it introduces the addition of 25 per cent of all interest (not only on long-term indebtedness) and on financing components of rentals and leases paid. The financing components are set at a flat rate of 20 per cent for moveables and 75 per cent for immovables. As this change affects leasing companies in general, it is also expected to have a major impact on the lease securitisation market. Although the Federal Ministry of Finance has published a circular stating that the discount representing financing components does not qualify as interest on long-term indebtedness for trade tax purposes, in future the discount will be considered to be fictional interest under the reformed tax regime and will be added to the trade tax base. This change will neutralise the financial advantage currently offered by lease securitisation over classic loan financing for leasing companies as originators. This particular feature of the tax reform may result in the implementation of securitisation structures ensuring that the actual seller of lease receivables is residing outside Germany.

Conclusion
The forthcoming changes will require substantial adjustments to securitisation structures in order to accommodate the tax reform implemented in the wake of Basel II. Although still in the early stages of the legislative process, it is already possible to identify the new challenges for which new structures will have to be devised.