31

Overview of the German securitisation market and recent legal developments

Sandra Wittinghofer
Baker & McKenzie

The first half of 2007 saw strong growth in terms of commercial mortgage-backed securities and asset-backed securities (ABS) term transactions. The two major asset classes securitised were auto loans and leases and small and medium-sized enterprise loans. One notable transaction in 2007 was BMW Leasing GmbH's Bavarian Sky SA transaction - the first time a double-tear leasing structure had been securitised as a term deal. Other notable transactions were the Breeze Finance SA transaction - the first German public transaction securitisation relating to cash flows generated by a pool of wind farms located in Germany and France - and Deutsche Bank's S-CORE 2007-1 GmbH transaction, which securitised *Schuldschein* loans extended to German and medium-sized enterprises.

However, after a promising start the year, the German securitisation market suffered from the market turbulence created by the credit crunch during the second half of 2007 and the first quarter of 2008.

Two conduits sponsored by German banks were particularly affected by the sub-prime events: Rhineland Funding (sponsored by IKB Bank) and Ormond Quay (sponsored by SachsenLB, the Sachsen state bank). Rhineland focused almost exclusively on collateralised debt obligations of ABS. Due to investors' caution in the wake of the sub-prime crisis, Rhineland was unable to roll over commercial paper on the commercial paper market, which led to a situation where the drawing of €8.1 billion of outstanding liquidity facilities granted by IKB Bank became imminent. Kreditanstalt für Wiederaufbau (KfW), IKB Bank's main shareholder, commenced rescue measures and assembled various other large German banks to join a €4.8 billion umbrella facility to prevent the insolvency of IKB Bank. Uncertainty about the risk profile of both

Rhineland's and IKB's assets forced KfW to assume all of IKB's liquidity obligations towards Rhineland. Despite these measures, market and investor confidence did not return as news of IKB Bank's further write-downs and losses reached the market. Although Ormond Quay had little collateralised debt obligation exposure, lack of investor confidence prevented the recovery of Ormond Quay. Even after the savings bank association granted a €17.3 billion credit facility to SachsenLB, the bank was sold to Landesbank Bad-Württemberg.

The overall market volume and number of transactions decreased significantly in the second half of 2007, most notably in the collateralised debt obligation market. In addition, the ABS market was then characterised by increased spreads and fewer transactions.

The only two cash ABS transactions in Germany publicly placed in the latter half of 2007 were initiated by Volkswagen Bank GmbH with VCL No 10 SA and Driver Five GmbH. Both are repeat structures of auto assets (loans and leases) which generated satisfactory demand with investors. Postbank's transaction PB Consumer 2008-1 GmbH was closed in 2008, but was retained by Postbank.

The asset-backed commercial paper market also experienced extremely low issuance of commercial paper in August and September 2007. Although there was overall reduced market activity, the asset-backed commercial paper market has slightly recovered since October 2007 and has picked up in issuance and funding levels. However, depending on the asset portfolios and identity of sponsors, some conduits have more difficulty in issuing commercial paper than others and have to rely on alternative sources of funding.

Investment Act strengthens German investment market

In November 2007 the German Parliament passed an act amending the Investment Act, which came into force on December 28 2007. It is designed to modernise German investment fund laws significantly and to strengthen Germany as an investment market. The key amendments relate to deregulation of the fund sector, including:

- waiving certain restrictions for German real estate funds;
- excluding certain foreign closed-ended funds from the scope of the Investment Act;
- abolishing the 'credit institution' qualification for conducting investment business;
- further harmonising national law with EU law; and
- improving the corporate governance of investment companies.

Directives implemented into German law

A significant financial regulatory development in 2007 was the act implementing the EU Markets in Financial Instruments Directive (2004/39/EC) in Germany, which entered into force on November 1 2007. The implementing act made significant changes to the Securities Trading Act and the Banking Act, as well as completely revising the Stock Exchange Act.

The German legislature also transposed the EU Transparency Directive (2004/109/EC) into German law. The relevant implementation act entered into force on January 20 2007 and amended shareholder notification requirements and publication and notification mechanics.

Anti-money Laundering Law to adopt risk-based procedures

On February 27 2008 the German government adopted the first draft of the German implementing act with respect to the EU Third Anti-money Laundering Directive (2005/60/EC) on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, as supplemented by the EU Implementation Directive (2006/70/EC). The implementing act will come into force later in 2008 and will amend the Money Laundering Act, the Banking Act, the Supervision of Insurance Companies Law and the Criminal Code.

The draft implementing act introduces the Third Anti-money Laundering Directive's risk-based approach. Anti-money laundering procedures and 'know your customer' principles will distinguish between the high-

risk category and lower-risk categories. Enhanced customer identification requirements are being introduced for politically exposed persons.

Supervision of Insurance Companies Law

In addition, in Summer 2007 the German Parliament passed an amendment to the Supervision of Insurance Companies Law incorporating the EU Reinsurance Directive (2005/68/EC) into German law. The amendment regulates supervisory issues relating to the securitisation of insurance risks.

Draft Risk Limitation Act concerns market participants

Early in 2007 the federal government announced its intention to react to undesirable activities of individual financial investors. In Autumn 2007 the Ministry of Finance presented a draft bill to limit the risks associated with financial investments and invited associations and business circles to comment. The Investment Risk Limitation Act is expected to come into force in 2008.

The purpose of the act is to create a legal framework which circumvents and prevents undesirable activities of financial investors, without affecting financial and corporate transactions that enhance efficiency. However, the proposed regulations affect other investors as well as financial investors. The draft bill contemplates various measures that will restrain the legal situation for investors participating in listed companies. The proposed changes affect the Securities Trading Act and the Ordinance Specifying the Duties to Report, Notify and Publish and the Duty to Maintain Insider Registers according to the Securities Trading Act, the Securities Acquisition and Takeover Act, the Stock Corporation Act and the Works Constitution Act.

Furthermore, the draft proposes to add provisions to the bill to improve transparency in connection with the sale of loans to protect borrowers, in particular for retail mortgage loans. To this end, the draft wording also introduces statutory notification requirements and extraordinary termination rights of the borrower upon assignment of a loan or change in the lender to which it has not consented. In addition, banks would have to:

- offer non-assignable loans;
- make a follow-up offer; or
- notify the borrower of the non-renewal of a loan no later than three months before the end of a fixed-rate interest period.

These provisions would directly affect the assignability of mortgage-backed loan portfolios. The new provisions would give corporate borrowers the right to exclude assignability of the loan contractually – under existing law, such contractual provisions of non-assignability among merchants are void by virtue of Section 354a of the Commercial Code. Market participants are addressing this concern within the legislative process.

Corporate tax reform 2008

Following the 2008 tax reform:

- the corporate income tax rate was reduced to 15.8 per cent (including the solidarity surcharge) as of January 1 2008; and
- trade tax is levied at approximately 14 per cent (depending on the municipality in which the respective taxpayer is resident).

From an originator's perspective, trade tax has recently become an important issue when selling receivables. Trade tax income is based on the profit for (corporate) income tax purposes, adjusted by certain add-backs and deductions. To the extent that interest expenses are deductible for corporate income tax purposes, the extended add-backs of interest and similar expenses for trade tax purposes need to be taken into account. Interest payments have always been subject to an add-back to the taxable income for trade tax purposes - for example, interest payments were only 50 per cent deductible for trade tax purposes. Since the sale of receivables in exchange for an upfront cash payment did

not (for trade tax purposes) include any interest charged to the originator, securitisations offered the possibility of trade tax arbitrage by financing a business through selling receivables as opposed to standard bank financing.

In terms of add-back rates, the concept has been limited such that the general add-back rate is 25 per cent of the interest payment. The add-back of the various interest components applies only to the extent that the sum of all financing components exceeds an annual exempt amount of €100,000. As from January 1 2008, the add-back of financing components also includes discounts in the sale of bills of trade and other cash receivables by reference to their interest equivalent character (Section 8(1) of the Trade Tax Act).

Following the 2008 tax reform, the scope of add-backs for trade tax purposes has been significantly broadened: the concept is now limited such that the general add-back rate is 25 per cent of the interest payment and the add-back of the various interest components applies only to the extent that the sum of all financing components exceeds an annual exempt amount of €100,000. Furthermore, discounts in the sale of bills of trade and other cash receivables by reference to their interest equivalent character are now deemed to have interest equivalent character (Section 8(1) of the Trade Tax Act). Therefore, the possibility of trade arbitrage has been abolished and the German tax legislature has gone far beyond this. Although the general goal of the statutory changes to the Trade Tax Act appears to be clear (ie, the equal tax treatment of economically equal financing alternatives), the details necessary for practical implementation of the new rules are still unclear. The statute itself does not specify which components of usual discounts (eg, financing, risk factors and administrative costs) are caught. The latest draft of a decree issued by the Ministry of Finance dealing with the interpretation of the statute states that all components of usual discounts are covered by the scope of the amended Trade Tax Act. Since discounts in securitisation transactions are often used to cover not only refinancing expenses of the purchaser, but also other risks (eg, defaults and dilution risks and/or administration reserves), in some cases the sale of receivables may become more expensive for the originator than standard bank financing. In future, securitisation transactions must be structured more carefully with respect to potential trade tax expenses.

Banking secrecy

Substantial uncertainty was created in the market in 2004 when, in a proceeding relating to a preliminary injunction against the enforcement of security by the assignee of the loan, the Frankfurt Court of Appeals gave summary judgment holding that the banking secrecy rules applying to German law-governed loan agreements could be construed to imply a contractual prohibition on the assignment of the corresponding loan receivable, with the effect that an assignment would be void. After this position was rejected by the majority of German commentators and subsequent decisions of other regional court of appeals held otherwise, the Federal Supreme Court ended the discussion with a judgment in February 2007 setting forth that the assignment of loan receivables is valid even if the assigning bank violates either banking secrecy rules or data protection rules in making the assignment. However, the Federal Supreme Court did not rule out that the debtor may have a claim for damages resulting from the violation of banking secrecy rules or data protection rules. The Federal Constitutional Court confirmed this judgment in a decree of July 2007 and held that in case of a transfer of loans, the related transfer of information does not contravene constitutional rights of the borrower.

Securitisation Law discussed again

Although the German market operates reasonably satisfactorily within the existing legal framework, from time to time market participants discuss and lobby for a consolidated securitisation law. While this is not yet a formal legislative proposal, the market has recently again picked up this discussion.