REAL ESTATE SECURITISATION IN GERMANY

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ABSTRACT

This paper discusses equity and debt securitisation in Germany and its implications for the property industry. Based on the current market environment the key drivers of change that will lead to an increase in equity and debt securitisation within the next five years are discussed. Furthermore, the crucial legal requirements and restrictions that will determine the future success of German real estate securitisation are identified.

In terms of real estate investment, Germany is the biggest market in Europe. Nevertheless, the total securitised real estate equity has only been €7 billion as of August 2005. It is broadly anticipated that the introduction of REITs in Germany will promote a fast expansion of the listed property sector. Particularly by eliminating the current tax disadvantages and by providing corporates and private equity investors with an attractive exit vehicle for their property portfolios.

On the debt side, 70% of all German real estate is funded through the use of traditional bank loans. Apart from synthetic debt securitisation structures and the German Pfandbrief market, which exceeds a volume of over €1 trillion, international capital market instruments have not yet been established. However, recent changes in the German legal landscape have opened the door for true-sale securitisation deals. The advantages of true-sale transactions, such as higher LTVs, will determine the significant expected growth in the German real estate debt securitisation market.

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1 Introduction

Real estate is no longer an illiquid and intransparent asset class when it comes down to indirect investment vehicles. Whereas direct real estate investment and private debt funding requires detailed analysis and specific expertise of properties and property markets themselves, the capital market enables investors to participate in the equity or debt income stream of real properties without facing the disadvantages of this capital intensive and heterogeneous asset. Despite real estate being a local business, institutional investors are increasingly scattering their portfolios internationally. The debt capital markets have long integrated into a global environment, but many property markets such as Germany still fail to benefit from international sources of funding.

Within the trend towards real estate investment market globalization, domestic markets have to adapt to international industry standards in order to reduce information asymmetries for foreign investors and to eliminate the management effort of investing into real estate. International investors prefer to invest indirectly into real estate, particularly into products they already know from their domestic markets. Therefore, the introduction of Real Estate Investment Trusts (REITs) has become a key success factor for economies in attracting foreign capital. REITs have in fact become the international industry standard for indirect real estate investments. However, the German market for equity securitisation is still very immature: Whereas non-listed vehicles such as open-ended and closed-end funds have been very successful in attracting capital from domestic private and institutional investors, the listed sector has underperformed all other asset classes in the past.

Similarly the German real estate debt securitisation market has not fully matured due to legal obstacles so far. Yet, debt securitisation has become a very important aspect of capital markets and in particular for the property industry internationally. The market for Asset-Backed-Securities (ABS) provides an additional source of capital for the industry as well as a funding source for banks that give out real estate loans and that want to relieve regulatory capital. The market still expects ABS products to have a growing impact on the financing of the property industry.

This paper analyses the current market environment for real estate equity and debt securitisation in Germany and determines the key drivers of change that will promote growth within these sectors. The paper determines furthermore the remaining legal obstacles and the impact of a maturing real estate securitisation market for the property industry as a whole.

2 Equity Securitisation in Germany

2.1 Current Real Estate Investment Market Environment

The value of all German properties amounts to approximately €5,533 billion, of which 58.3% comprises residential properties and the remaining 41.7% are properties of different types of use.[1]

The German commercial real estate investment market amounts to €1,075 billion and therefore forms the third largest in the world after the US (€4,997 billion) and Japan (€1,966 billion). Despite being the largest commercial real estate market in Europe, the proportion of securitised real estate in respect to the total value of real estate is approximately 0.49% in Germany. In terms of real estate equity securitisation, Germany is therefore at the lower end of the distribution of real estate securitisation levels in Europe.[2]

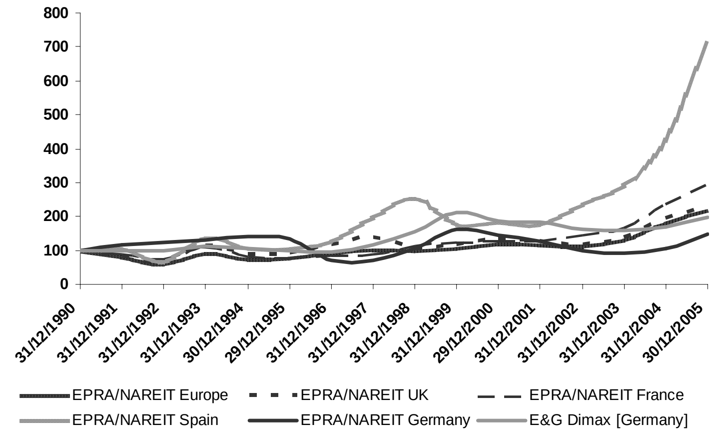
From a performance perspective, the German listed property market has underperformed other real estate sectors. As can be seen in Exhibit 1, German listed property stocks performed worse than any other European public real estate markets.

[1] See IFO (2005), p. 6.

[2] See EPRA (2006), p. 6. The average securitised real estate proportion of total real estate across Europe is estimated at 2.69%, the worldwide average at 5.66%.

Exhibit 1: European Real Estate Stocks

("E&G Dimax" only until 31/08/2005)



This is due to the fundamentally different structure of the German real estate investment market: Whereas in the US, UK and in France the listed real estate sector has established itself as an indirect real estate investment market, in Germany only a few listed companies are recognized as alternative ways of investing indirectly into real estate. Non-listed vehicles like the open-ended and closed-end funds have dominated the indirect investment market in Germany. In terms of fund volume and market capitalization, as of November 2005 the open-ended mutual funds ranked number one with a total fund volume of €88.5 billion.[3] Loipfinger (2004) estimates the total equity invested by German closed-end real estate into German real estate at approximately €60 billion and approximately €20 billion more in non-German properties in 2003. Whereas the equity of closed-end funds is almost entirely invested into real estate, only 67% of the equity fund volume of open-ended mutual funds is invested into real estate assets.[4] In terms of real estate ownership, the closed-end funds sector is therefore even larger than the open-ended mutual funds sector. The third largest indirect real estate vehicles are open-ended special funds with a €14.4 billion of equity fund volume.[5] This vehicle is only targeted at institutional investors. Listed real estate companies rank last with a total market capitalization of only €7.52 billion as of August 2005:[6]

[3] See BVI (2006).

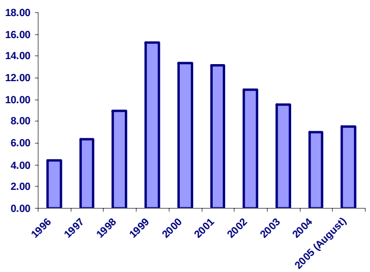
[4] See BECKER et al. (2005), p. 110.

[5] See ENTZIAN / KANDLBINDER (2005), p. 7.

[6] Data: ELLWANGER&GEIGER, BLOOMBERG, HSH NORDBANK.

Exhibit 2: Market Cap of German Real Estate Stocks

Market Cap E&G Dimax (€ Bn)



Top German Real Estate Stocks

in Million EUR	Market Cap	Free Float	Tradable Market Cap
IVG Immobilien	1,995	75%	1,496
Deutsche Wohnen	767	94%	721
Deutsche Euroshop	710	79%	561
Vivacon	511	65%	332
AIG Int. Real Estate	124	70%	87
Dt. Beamtenvorsorge	81	100%	81
Hamborner	229	31%	71
TAG Tegernsee	82	45%	37
Anterra	65	50%	33
DIBAG Industriebau	504	5%	25
B&L Immobilien	198	11%	22
other Stocks	1,941	10%	194
Total	**7,207**	**51%**	**3,660**

2.2 Key Drivers of Change

2.2.1 Institutional Investors Demand for REITs

Institutional investors have already stated their great expectations and interest in securitised real estate investments via a German REIT. On average, they currently invest only approximately 5% of their total asset allocation into real estate.[7] The share of direct real estate investments of the total asset allocation decreased from 3.0% in 2000 to 2.0% in 2004.[8] Therefore, the proportion of indirect real estate investments within the real estate asset allocation already amounts to 60% in terms of book value. According to the German Insurance Association (GDV) the 5.0% real estate proportion on the basis of book values represents €65 billion in terms of market value. However, the proportion of indirect real estate investments might be lower than the stated 60%, since participations in open-ended funds are market value based within the balance sheets of institutional investors. According to Becker, Bone-Winkel and Sotelo (2005), the estimated proportion of indirect real estate on a market value basis has been 29% as of 2004; securitised real estate contributes not even 1% to the real estate assets of institutional investors.[9]

To a major part, indirect real estate investments of institutional investors are made through open-ended special funds. They amount to approximately 18% of the total real estate asset allocation.[10] The current significance of non-listed vehicles is due to several reasons: (1) institutional investors used open-ended special funds to outsource some of their direct investments by setting up these externally managed vehicles, (2) open-ended special funds do not have maximum ownership requirements and therefore provide the opportunity to invest indirectly despite retaining management control and (3) listed vehicles in Germany so far do not provide a tax neutral structure and are not regarded as real estate investment by the German Insurance Supervision Act.

However, the key driver for the success of open-ended special funds has been the lack of alternative ways of investing indirectly into real estate in Germany. The structure has been criticised as being too costly due to the fee structures of the management entity. Apart from being regarded as part of the stock proportion of the institutional reserve funds, listed vehicles are not attractive in any regard, because of the taxation on the entity's level. Whereas private investors can to a certain extend impute taxes paid before dividend distributions to their personal tax liabilities, for German

[7] See GDV (2005), p.136.
[8] See GDV (2005), p. 14.
[9] See Bone-Winkel / Becker / Sotelo (2005), p. 15.
[10] Ibidem.

institutional investors such as life insurances and pension funds any tax on the level of the entity reduces the performance of the vehicle; they only have to pay tax on 5% of their income from reserve fund investments and therefore do not benefit from the imputed tax system. A tax neutral vehicle like a REIT will not suffer from this disadvantage and is expected to attract funds from the institutional investors' side.

2.2.2 Private Investors Demand for REITs

The majority of private investment into indirect real estate in Germany takes place through open-ended mutual funds and closed-end funds. The aims of investors, choosing one or the other vehicle, are different in their nature. Consequently so are the drivers that may lead to a shift towards securitised real estate.

Shift from closed-end funds

Closed-end funds are vehicles that invest into one of up to three properties with a usual time horizon of five to ten years. During this period, the fund manager is not obliged to redeem the units. The investor however cannot sell the units to another party without any friction. Recent attempts to establish a exchange traded secondary market for closed-end fund units at the Hamburg based "Fondsbörse Deutschland" and the Düsseldorf based "Fondsbörse Gefox" have failed due to low trading volume and discounts up to 50% of nominal value.

In the early 1990s demand for closed-end fund units increased as a result of special depreciation of an initial 50% of property value for investments in the "New Laender". Whereas private investors were commonly drawn to closed-end fund investments due to tax reasons, a trend towards total return orientated funds can be observed. Particularly due to changes in the Personal Income Tax Law that will limit tax loss imputation on other income sources.

Private investment in closed-end funds is long-term focused. Because of the absences of a secondary market, investors require a liquidity premium. REITs are expected to be seen as an alternative investment opportunity for closed-end fund investors. However, the advantage of securitised real estate as alternative investment to closed-end funds will depend on the risk return characteristics of German REITs: On the one hand investors do not require a lower liquidity premium for REIT investments, but on the other hand they sense a higher volatility despite their long-term investment horizon.

Shift from open-ended mutual funds

Open-ended mutual funds have been very successful on a risk-return basis over the last several years. Private investors use this vehicle for long-term investments into commercial real estate, mainly office and retail. Yet, they benefit from the daily redemption requirement of open-ended mutual funds, which enables investors to cash out on a daily basis. Despite strong capital inflows particularly from 2001 to 2003, they have suffered from the bad real estate market performance in the last years.

In particular the redemption requirement of German open-ended funds and the non-tradability of fund units result in major differences between REITs and open-ended mutual funds. Open-ended funds hold large proportions of non-real estate assets and are not authorized to specialise their investment portfolio on regions and certain property types by the German Investment Law. Since the units are not traded but redeemed, the value of each unit is derived by valuation instead of transactions. Due to the valuation practice, the funds' performance and risk are smoothed and depend on the appraiser's estimate of the fair unit values. The absence of a secondary market makes the funds vulnerable to both, large capital inflows and outflows. This is caused by the incongruity between the term structure of the underlying assets, i.e. long-term and illiquid real estate, and the flows from funding, i.e. medium- to long-term and liquid participation units. In times of large capital inflows, the funds initially reduce their gearing ratios and build up liquidity. In times of large capital outflows, the funds reduce the proportion of liquid assets and increase the level of gearing. Only in extreme case the funds are forced to buy and sell properties during adverse market conditions or exempt the redemption of units.

In 2004, the whole sector was hit by a valuation and corruption scandal, when properties of the "Deka-ImmobilienFonds", one of the largest open-ended mutual funds with assets worth €4.925 billion as of 3rd Quarter 2005, proved to be significantly overvalued. More recently, in December 2005 the fourth largest open-ended mutual fund "DB Real Estate grundbesitz-invest" suspended the redemption of units due to expected negative valuation adjustments of 20 to 30%. Whereas in the beginning of December 2005, the stock price of Colonia Real Estate AG was still at 40 Euros/share, on the announcement day of the fund suspension its stock price increased to 60 Euros/share.[11] This represents a rising awareness of German property stocks as an alternative way of investing indirectly into real estate to non-listed open-ended mutual funds.

The increased awareness of the product's disadvantages has led to an increase sensibility for alternative investment opportunities. REITs are therefore expected to attract capital from traditional open-ended fund investors. Furthermore, the fund managers broadly anticipate REITs as an additional investment product for them to set up, or outsource property portfolios from former open-ended funds. Therefore, not only demand from the open-ended mutual funds' investors perspective can be expected, but also the pressure of fund issuers to shift properties into new vehicles.

2.2.3 Increasing Direct Supply of Real Estate for Securitisation

Capital Flows into Listed Vehicles

In essence, the similarities of existing German property shares and REITs are restricted to the real estate investment focus and the predominant stock listing. However, German property shares do not represent a homogeneous stock market segment, which is furthermore fairly illiquid and poorly accepted by investors: Apart from the low market capitalization the free floating market cap of German property stocks only amounts to €3.66 billion as of December 2005.[12]

Since the official announcement that the German Ministry of Finance is willing to introduce a German REIT structure – providing no negative effects on the tax revenue due to the potential tax leakages –, German property stocks have benefited from large capital inflows into the sector. Thus, making it more attractive for property companies to go public.

Real Estate Securitisation as Exit Strategy for Private Equity Investors

Since the beginning of 2004 Germany is subject to increased activity of foreign direct real estate investment: Whereas 2002 and 2003 the total real estate investment from foreign investor was €1.2 billion and €1.5 billion respectively, in 2004 €9.8 billion went into German property from foreign investors.[13] To the largest extend, these funds came from Anglo-Saxon private equity investors aiming at German residential portfolios. According to Ernst&Young (2005), the private equity activity within the real estate sector increased even further to a buyout transaction volume of approximately €10.5 billion in 2005.[14] These funds predominantly aim at a maximum holding period of five to seven years. For end of 2006, the first large residential property IPO has already been announced by Fortress Investment Group that acquired two large residential portfolios in 2004

[11] See WELT (2005).
[12] See EXHIBIT 2.
[13] Data provided by BULWIENGESA (2005).
[14] See ERNST&YOUNG (2005), p. 7.

and 2005 for a total purchase price of approximately €5 billion.[15] The introduction of REITs in Germany is expected to further increase the attractiveness of IPOs as an exit strategy for private equity investors thanks to a more favourable and larger market segment.

Corporate Real Estate Spin-Offs

According to Schulte and Gier (2005), the total value of German corporate real estate suitable for privatization amounts to at least €80 billion.[16] Jones LangLaSalle (2002) estimated the owner-occupancy ratios across Europe to be approximately 67%, whereas the average owner-occupancy ratio in the U.S. is approximately 24%.[17] In Germany, the introduction of REITs is believed to be an opportunity for corporates to spin-off their non-specific real estate ownership. For now, this has not been possible because existing vehicles are not able to invest into non-diversified portfolios. As well the stock market environment has not been favourable.

2.3 Critical Success Factors and Outlook for German REITs

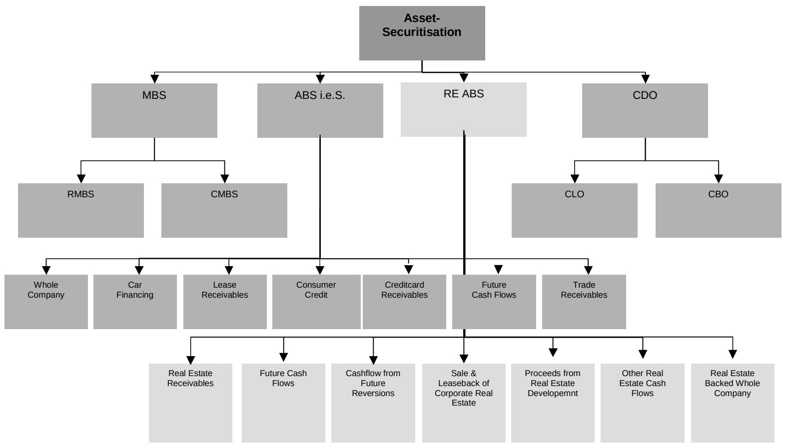
The final success of a German REIT highly depends on the regulations that govern the vehicle. As in established REIT regimes, these regulations include the legal form, capital requirements, obligation of exchange listing, shareholder requirements, investment restrictions, level of gearing, distribution requirements, corporate governance, control of REIT status, sanctions for the loss of REIT status and adjacent regulations for institutional and private investors.[18] However, these economic factors have not been the key burdens of introducing REITs in Germany, but some specific problems associated with the taxation of foreign investors. The key issues are: (1) securing withholding tax on distributions to foreign investors and (2) the taxation of non-resident REITs on their domestic real estate investments. For the first issue the solution is fairly obvious but at the same time hard to achieve: In order to secure withholding tax under current double taxation agreements (DTAs), income from REITs must be classified as income from property. Unless explicitly stated within the DTA, distributions from REITs in the form of a (listed) company are classified as dividends per se and are subject to withholding tax reduction to five or zero percent with an ownership ratio of at least 10%. Now there are two proposals of alternative REIT regulations that are likely to enable the German treasury to withhold tax on distributions. One of the two proposals is based on a uniquely German legal fundament, which on the one hand separates the rental and capital gains income from the response entity and on the other hand is not achievable under non-domestic law without overriding existing DTAs. The other proposal requires the REIT to provide the shareholder with a usufruct right on the property income, which is not regarded as income from dividends under existing DTAs. Both proposals appear achievable and the introduction of REIT in Germany is plausible for the end of 2006.

[15] See HSN NORDBANK (2005), p. 77; KEMPEN & CO. N..V. (2005), p. 6.
[16] See SCHULTE / GIER (2005), p. 17.
[17] See JONES LANG LASALLE (2002), p. 1.
[18] For a detailed discussion on the critical regulatory environment see BECKER et al. (2005), EPRA (2004) and EPRA (2005).

3 Debt Securitisation in Germany – ABS and CMBS

Debt securitisation has had a significant impact on property finance. The array of assets that qualify for a securitisation is expanding every day along with the complex transaction schemes that can be structured to fit different needs. The application to a variety of asset classes and its innovative qualities have led Asset-Backed-Securities (ABS), with all of its sub asset classes, to become a new and innovative financing source for the property industry. ABS is the parent asset class for widely known financial instruments, such as Collateralized Debt Obligations (CDO), Mortgage Backed Securities (MBS) and Asset Backed Securities in a narrower sense (ABS i.n.s.). Please refer to Exhibit 3 for the asset categorization and delineation:[19]

Exhibit 3: Asset Categorization (incl. Real Estate Asset Backed Securities)



3.1 Current Market Environment

3.1.1 Asset Backed Securities

The ABS market in Europe has experienced significant growth over the last few years. The European issuance volume has almost tripled from €80 billion in the year 2000 to approximately €235 billion presently.[20] This is a consequence of the expanding array of securitisable assets, the continued innovation that this segment is facing, and the continued appetite for ABS from European investors.[21] The biggest asset type is the market for Residential Mortgage-Backed Securities (RMBS), which comprises 42.9% of all issuances in 2005, followed by CMBS and CDOs. The amount of leases that are securitised in Europe amount to only 1%, although the market for Credit Tenant Lease (CTL) securitisations is expected to become a new sector for growth. Over half of all

[19] See BREIDENBACH (2005), p. 51.
[20] See WÖLWER (2005), p. 2.
[21] See MURRAY / JONES / BEDELL (2005), p. 21.

deals are originated in the UK, which demonstrates how the UK capital markets benefits from restrictive regulatory environments in other European countries, such as Germany.

Among the most important sub-asset classes of ABS are CMBS, as they account for 24% of all European ABS emissions. Many European countries either have (example Belgium) or will enact comprehensive legislation regulating debt securitisation. This new regulatory framework has partially contributed to the growth of this asset class.[22]

3.1.2 Mortgage Backed Securities (MBS)

MBS are bank-originated securities that are backed by a pool of either residential or commercial mortgage loans. These securities represent payment claims against a Special Purpose Vehicle (SPV) that are backed by a pool of secured loans, i.e. mortgages that comprise cash flows from real estate loans.[23] The focus in this paper will be on the commercial side of this asset class, the CMBS.

European CMBS issuance has reached an all-time high. By an increase of 18.75% the CMBS volume has reached €19 billion in new issuances.[24] The most active market remains the UK, but the growth is to be found in continental Europe, namely Germany, the Netherlands and Italy. There is no generally accepted CMBS structure that has claimed dominance in the market. Oftentimes, single borrower deals are too small for the securitisation process as the structuring costs may outweigh the benefits such as higher LTVs and lower overall rate of debt. As a result there has been strong growth in Pan European conduit programs, which originate loans, warehouse them and then securitise them through their respective conduit platforms, most of which are located in the UK. Just one example for increased use of conduit structures is HSH Nordbank, a German mortgage bank. They have established Poseidon Limited Funding, a €1 billion conduit program set up in London.[25] This trend will continue and has a positive effect on the property industry, as these conduits tend to be more aggressive in generating loans. However further study is warrant to analyze what impact the increased supply of funds (through the conduit) has on the overall financing costs of the property industry participant.

3.1.3 Investor Demand

The ABS investor composition in Europe has changed dramatically from five years ago. Whereas the majority of investors were composed of banks managing their liquidity needs, a new brand of investor has emerged which includes newly formed fixed income funds, structured investment vehicles (SIV), CDO and money market funds.[26] This has caused traditional investors, with the already existing analytical skills to accurately assess the risk, to move down the credit line to more risky tranches. During the years 2004 and early 2005 many investors were drawn to the ABS asset class due to the yield pick-up of ABS tranches relative to corporate bonds.[27] This increased demand coupled with the persistence of the 'traditional players' have caused a tightening of spreads across all ABS transactions, as investor demand is outpacing the strong supply side. This particularly applies to the AAA spreads. Please refer to the Exhibit 4:[28]

[22] See HELMS / SCHÖNIGER (2005), p. 293.
[23] See BREIDENBACH (2003), p. 4.
[24] See MURRAY / JONES / BEDELL (2005), p. 39.
[25] See ANON (2005), p. 3.
[26] See MURRAY / JONES / BEDELL (2005), p. 21.
[27] See Ibidem, p. 22.
[28] See RAJENDRA et al. (2005), p. 229.

Exhibit 4: AAA Spread Comparison by Year

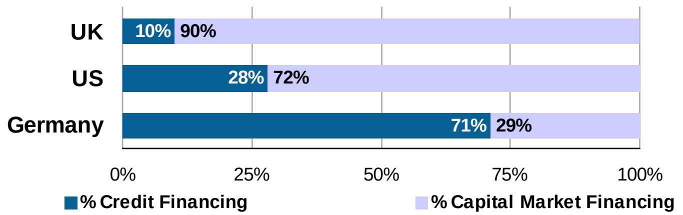
AAA spread Comparison by year (bp)			
Asset Class	**2002**	**2003**	**2004**
Prime MBS	20	13	9
Non conforming MBS	29	40	15
Credit Card ABS	19	16	12
CMBS	42	43	21
Managed CDO	60	58	33
SME CLOs	40	25	12

As one can tell from Exhibit 4, the spreads have decreased significantly from 2003 to 2004. Part of the reason is the relatively low yield of corporate bonds and the emergence of a new kind of real estate capital market investors, such as the funds mentioned above.

3.1.4 German Commercial Mortgage Backed Securities (CMBS)

Although CMBS issuance has experienced tremendous growth in Europe, Germany is still lagging behind in the number of true sale transactions. In 2004 there were only two true sale CMBS deals totalling €879 Million.[29] The majority of transactions in Germany are synthetic deals. These transactions only transfer the risk associated with the underlying loans, but the assets remain on the originators balance sheet. The loan default risk is transferred to investors in the form of credit derivatives.[30] This form of structuring is more efficient, because there is no need to set up and service a SPV, because all loans remain with the originator. However, this form of CMBS structure has comparative downsides to a true sale transaction. This will be addressed in a later section of the paper.
The main reasons for the prevalent use of synthetic deals as opposed to true sale transactions are the regulatory and tax issues that originators have been facing in Germany – ranging from Value Added Tax problems to problematic assignability of assets and bankruptcy remoteness of the SPV. All of these issues are key ingredients to any securitisation structure and hence have lowered the potential for true sale securitisation in Germany until recently.

Exhibit 5: Traditional vs. Capital Market Financing [31]



In Germany 71% of all funding is generated through the use of traditional bank lending, as opposed to the UK, with only 10 % and the US with 28% (Exhibit 5). The balance is funded through the use of the real estate capital markets, an area that still needs to fully develop in Germany. Germany is

[29] See WÖLWER (2005), p. 3.
[30] See MURRAY / JONES / BEDELL (2005), p. 39.
[31] See HAGEN (2003), p. 41.

facing a situation in which key drivers have emerged that have pushed the industry groups and the government to see eliminating the obstacles mentioned above as a priority in order to develop a functioning real estate capital market, with debt and equity securitisation for the property industry.

3.2 Drivers of Change

The development of this important financial market depends on the regulatory framework that governs the marketplace. In Germany the regulatory environment was not conducive to true sale real estate debt securitisation until fairly recently. The key catalyst for the development of a mature German true sale CMBS market will be the enacting of the Basel II Capital accords, the emergence of the Non-Performing Loan (NPL) market and the pressure to find innovative ways of funding for non-real estate corporates.

3.2.1 Basel II

The Basel II accords were introduced in 1999. In 2004 the final version of the accords were published and have to be implemented by each country by the year 2007. The accords were designed to more closely match regulatory capital to the actual risk exposure. The accord is based on three pillars:

i) minimum regulatory capital,
ii) guidelines for an institution’s capital adequacy and internal assessment process,
iii) guidelines pertaining to the effective use of market discipline.

For the purpose of this paper, the impact of Basel II on the market for real estate securitisation will be illustrated with reference to pillar i). The minimum capital requirement in the standardized approach stipulates that the capital charge is calculated as follows:

Capital Charge = (amount of exposure) X (risk weight) X (8%)

The risk weighting has a significant impact on the underlying regulatory capital. Please refer to Exhibit 6 to determine the risk weighting based on credit quality.

Exhibit 6: Long Term rating Category under Basel II

Long-term rating category					
External Credit Rating	**AAA to AA-**	**A+ to A-**	**BBB+ to BBB-**	**BB+ to BB-**	**B+ and below or unrated**
Risk Weight	20%	50%	100%	350% *	Deduction from Capital

* Only Investment Banks

The Basel II accords are very important for securitisation in Germany as banks will have to reserve more regulatory capital for higher risk loans. In essence this will push banks to reassess their portfolio and dispose of disadvantageous or risky loans. Especially real estate loans will be valued at a higher risk and hence will cause banks to actively manage their loan portfolio through disposition of selected loans. These loans in turn can be warehoused and then securitised through a true sale CMBS deal.
The advantage of a true sale transaction as opposed to the synthetic structures is that the bank can free up regulatory capital by disposing of the loans, at the same time retaining funding and selling the loans to an outside party via true sale. This will allow the bank to take the loans off the balance

sheet and hence relieve regulatory capital. Another big difference between true sale and synthetic structures is the issue of funding. In a synthetic deal, the bank only sells off the risk, but does not retain funding, nor can the loan portfolio be taken of the books. The strong demand by German mortgage banks to do true sale CMBS deals and be able to better actively manage their portfolio, has been a major factor in the lobbying process for an improved regulatory environment in Germany.

3.2.2 Non-Performing Loans (NPL)

Another driving force behind the continued effort to lobby the German government is the large amount of NPLs on German banks' balance sheets. The nominal value of NPL assets held by German public and private banks was estimated between €200 billion and €300 billion.[32] Albeit a steady amount of private NPL portfolio transactions in the last year in Germany, it is anticipated that this trend will continue. Many banks want to use public capital market instruments, such as CMBS, to sell off their NPL portfolios.

This drive to securitise the NPL portfolios has led an association of 13 German banks to found the True Sale Initiative (TSI), an industry lobbying group to push for change in tax legislation as well as other regulatory amendments. The continued lobbying effort on behalf of German banks has improved the pressure on the legislator to implement various pieces of legislation, such as the Refinancing Register, which combined promote a favourable securitisation environment in Germany.

3.2.3 Corporate Real Estate Disposition

Another driver in Germany for the development of real estate capital markets is an unlikely candidate. Many German corporates have large portfolios of real estate, which could enable them to raise liquidity through disposition via the capital markets. Although many corporates are focused on the disposition of assets through an equity securitisation, there is a lot of potential for a combination of debt and equity securitisation due to the make up of most corporate real estate portfolios. In every corporate real estate portfolio there are buildings that are company specific and others that could be sold and used by a third party. To divest of the disposable, meaning non-essential to the firm and usable by a third party, real estate, an equity securitisation in the form of a REIT is the preferred exit strategies for corporates. However, the company specific portion of the portfolio can also be sold, through a Credit-Tenant-Lease (CTL) securitisation. A REIT would face some difficulty going public with a portfolio that is to 50% occupied by one tenant namely the corporate who originated the deal. That is why for the part of the portfolio, which is company specific, long-term leases would be signed by the former owner. The cash-flows that originate from that long-term lease agreement will be securitised in the form of a CTL deal. In Germany there have only been two deals using this debt securitisation product, namely Deutsche Bank and Deutsche Telekom.[33] It is estimated that the areas of lease securitisations will grow substantially with a European-wide estimated growth rate of 198% over the next 12 to 18 months.[34]

3.3 Trend towards True Sale Transactions in Germany

As mentioned before, the regulatory environment in the past handicapped many German real estate capital market participants. The primary constricting factor was the issue of taxes. Through the catalysts and drivers mentioned above, the German securitisation framework has improved significantly compared to only 5 years ago. This section will highlight some of the regulatory

[32] See KLÜWER / VASU / WELLER (2005), p. 5.
[33] See SCHULTE / GIER (2005), p. 2.
[34] See RAJENDRA et al. (2005), p. 226.

changes and amendments that primarily affect mortgage securitisation, to demonstrate the progress that has been made.

3.3.1 Trade Tax Exemption for SPVs

The biggest damper for the development of a true sale securitisation market in Germany was the issue of a tax neutral SPV. The concern of the market participants was that the SPV might have triggered a trade tax (Gewerbesteuer), ranging from 11% to 19% and hence would make true sale securitisation deals not economically feasible. In Germany 50% of the interest payable on the financing raised by the SPV would be added to the tax base and create a tax liability, even if the SPV did not generate any profit.[35] While German and foreign banks of permanent German branch office were exempt from this '50 percent rule' this special banking privilege did not extend to the SPVs. In late 2003 the German government extended this trade tax exemption to SPVs that are buying receivables and credit risks and that fulfilled the criteria that underlying assets were originated by German or foreign banks with a German branch office. This tax exemption made it possible to establish tax neutral SPVs for the securitisation of MBS.

3.3.2 Refinancing Register

In July 2005 an amendment to the German Banking Act (Kreditwesengesetz) was introduced that is designed to pave the way for true sale MBS. In essence this new amendment makes the transfer of registered mortgages much easier. Before this legislation it was time consuming and costly to transfer registered mortgages from the originator to the SPV. In order to protect the investors in the case of bankruptcy of the originator, the collateral must be bankruptcy remote. In the event of insolvency of an originator or a refinancing intermediary, the beneficiary claims and/or related security rights are registered for its benefit in the refinancing register and have a right to segregation (Aussonderungsrecht) of such asset.[36] This right of segregation allows the investor to protect the underlying assets of entering the bankruptcy estate, without having to transfer the actual asset. Through the pending implementation of this new Refinancing Register, the regulatory framework has developed an economically feasible true sale transaction structure in Germany for MBS.

3.4 Critical Success Factors for True Sale Securitisations in Germany

Germany has made significant progress in the formation of a regulatory environment that is conducive to a wide variety of securitisation deals. However, there are still issues that need to be resolved in order to develop a successful true sale ABS market.

So far most regulatory changes and amendments that apply to securitisation in Germany have been implemented through amendments to a variety of banking and tax laws. This patchwork approach has the consequence that originators lack a comprehensive legal framework that addresses all aspects of securitisation.

A good example for one area of uncertainty has to deal with the issue of data protection and trade secrecy laws. Most securitisation transactions require the disclosure of information pertaining to individual tenants in a securitised property, such as information pertaining to lease due diligence and more importantly historic default rates. However the data protection and trade secrecy laws could prohibit such exchange of information, between the originator and the acquiring entity. Trade secrecy laws prevent exchange of information with respect to commercial tenants. In mid 2004 the Frankfurt higher regional court held that the transfer of debt could be illegal in the event of non-compliance with the bank secrecy laws. Although there have been two subsequent verdicts that

[35] See THIELE et al. (2005), p. 256.
[36] See KREPPEL / WITTEK (2005), pp. 1-2.

overturned the Frankfurt higher regional court, it remains an area of uneasiness for banks, arrangers and originators alike.

The overall problem is the fact that securitisation touches on all areas of law and hence there may be legal issues that have not been considered in past transactions and legislation. In order to strengthen the confidence that investors, as well as arranger and originators have by writing and implementing a comprehensive Securitisation Law, that would govern all related issues as is done in other countries, such as Belgium.

4 Implications for the Real Estate Market

4.1 Evolution of Real Estate Capital Market

As has been illustrated in section two and three, Germany is experiencing a shift towards securitised products within real estate investment and financing. These shifts towards capital markets have large implications for the property industry itself: On the one hand innovative products will set a new benchmark, against which traditional vehicles or sources of financing will be measured in future. Already right now traditional vehicles are being challenged by these investment and financing alternative, because particularly the REIT market requires the legislator to establish a legal framework. Within the governmental consultation process the relative disadvantages of traditional products have been scrutinized in public: The German Ministry of Finance required the comparison of REITs with existing vehicles, asking for the benefit a REIT regime would have for the German real estate investment market as a whole.[37] In fact, the discussion on the introduction of REITs put the existing German open-ended fund regime as a benchmark for REIT legislation rather than considering international best practice guidelines. During this consultation process the public awareness for real estate investment products has been rising, entailing the prospect for flanking amendments to reduce deficiencies in the Investment Law governing German open-ended funds.[38]

On the other hand the originators and investors have to understand these products and demand more market information and a higher degree of transparency. This increased availability of data and accelerated information flow would enable the emergence of a better quality real estate research throughout the industry. Among other benefits, positive spill-over effects can be drawn to the entire sector, e.g. the potential for overbuilding is reduced as the research and public capital market analysts are capable of identifying the first sign of real estate market inefficiency.[39] The transparency of the public markets combined with the improved level of real estate research through more information cause the feedback loop between demand and supply to shorten. This shorten feedback loop will help to stabilize the real estate cycle and reduce its volatility, both of which are desirable characteristics for Germany.

4.2 Internationalisation of Investor Base

A second key benefit of the trend towards securitised products within the real estate investment and financing market is the reduction of entry barriers to foreign investors. Firstly, the adoption of international industry standard products enables foreign investors to better understand the different features of the German investment market and focus more on the fundamental aspects of the investment product, i.e. the risk-return characteristics, rather than the heterogeneous legal structure of the investment and financing vehicles: For foreign investors it appears more attractive to invest into products that they are already aware of from their own domestic market. The trend towards real

[37] See BECKER et al. (2005), p. I.
[38] The consultation document on the changes in open-ended fund regulation is available on the official website of the ministry of finance <http://www.bundesfinanzministerium.de>.
[39] See MUELLER (2000), p. 4.

estate securitisation in German is therefore expected to lead to an internationalization of the investor base. Hence, the German real estate market will benefit from increased liquidity in the equity market and greater availability of debt in the financing market. From the investors perspective the equity risk premium on real estate transactions will be reduced and the cost of capital optimized by alternative or additional sources of funding.

5 Conclusion

The German real estate investment market has been very intransparent and fragmented. Non-listed vehicles have been dominating the scene so far. However, institutional and private investors demand alternative ways of investing into real estate due to some defaults of the non-listed vehicles: The inefficient management fee structures of open-ended special funds, the double taxation of property stocks, the recent valuation scandals and liquidity crisis of open-ended mutual funds and the absence of a secondary market for closed-end fund units. For these reasons, the pending introduction of REITs is expected to broadly modify the domestic investment market landscape and to enhance the opportunities to invest into German real estate. The introduction of REITs is expected for end 2006, once the remaining issues regarding the taxation of foreign investors are solved.

As well, there is tremendous potential for Real Estate ABS or CMBS in Europe, especially in Germany. However this potential has not been realised in Germany, due to the difficult and murky regulatory environment. Although the German government has identified the need to address the legislative environment, it has opted to use a regulatory patchwork approach. This step by step approach concerns investors and originators alike as there have been areas of the trade secrecy laws, that have recently caused a controversial judgement by the Frankfurt higher court, which declared the transfer of loans illegal if it is in violation of some data protection provisions of the Banking secrecy law. The solution to this unforeseen friction, between new and existing legislation could be a comprehensive securitisation law. Once such a comprehensive securitisation law has been implemented, the strengthened confidence will draw many more players to the market. The potential for real estate debt securitisation is tremendous, due to the catalysts such as the large NPL portfolios held by German banks and the regulatory requirements under the Basel II accords.

It has become apparent that Germany is lacking the sophisticated, well regulated and efficient real estate capital markets that can be found in the US and in the UK. The German real estate industry and the related players are craving the rapid development of a capital market that allows for a variety of innovative products. The whole property market would benefit from the evolution of real estate capital markets: On the one hand flanking improvements within the non-listed sector can be observed due to the benchmarking against an efficient capital market product. On the other hand, the increased availability of data will cause the feedback loop between demand and supply to shorten and thus stabilizing the real estate cycle. The property market will furthermore benefit from an increase in market liquidity by a broader and more international investor base.

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