



German covered aircraft bonds

THE AMENDED GERMAN COVERED BONDS CODE PROVIDES FOR A NEW TYPE OF COVERED BONDS

German law will soon provide for a new type of covered bond in relation to aircraft financing. The amendment of the German Covered Bonds Code recently enacted by the German parliament (*Bundestag*) and German federal council (*Bundesrat*) will enable German and certain other European banks to issue covered aircraft bonds and by this means to refinance loans granted in connection with aircraft financing.

On 9 July 2008, the German Ministry of Finance announced a proposal for an amendment to the German Covered Bonds Code (*Pfandbriefgesetz*). The date of enactment is still open but the Ministry of Finance anticipates enactment in May 2009. The most important revision shall be the introduction of a fourth type of covered bond (in addition to real estate, public and ship mortgage bonds), the so-called 'covered aircraft bonds' (*Flugzeugpfandbrief*). The German Ministry of Finance expects that there will be a market for covered aircraft bonds worth €44bn annually over the next five years.

General background of German covered bonds

Covered bonds have been playing a major role in financial business over recent years, offering investors a fairly secure financial investment. The key point of German covered bonds is that the creditor's title against the bank is secured by special cover values out of which it can seek satisfaction in the case of the bank's insolvency. Therefore, the German Covered Bonds Code secures a permanent, sufficient matching cover relating to the cover values and the issued bonds.

Though many European jurisdictions provide for covered bonds, the German covered bonds have been by far the most attractive due to the size and maturity of the market (about 40 to 50 per cent of overall European volume after 240 years of experience) and their high standard of legal certainty, such as:

- constant supervision by the German Financial Supervisory Authority (*BaFin*): banks need a licence to conduct covered bonds business and those banks will be supervised by an independent custodian to avoid comminglement with general insolvency proceedings;
- 'matching cover' and 'excess cover': bond volume is restricted to the amount of the asset's nominal value plus the asset's net present value – loans may be covered up to only 60 per cent of the asset's value; and
- creditors are privileged in the case of the bank's insolvency.

The advantages of German covered bonds over foreign covered bonds are:

- codification (and 240 years' experience);
- public supervision;
- codified, precise procedures for evaluating the asset value; and
- no sub-prime risk.

The mode of operation of German covered bonds is as follows:

- a bank issues a credit;
- if security is provided for this loan according to the requirements of the Covered Bonds Code, the bank may hypothecate it and issue a covered bond;
- the possible securities are: real estate mortgage, ship mortgage, public debenture and, from spring 2009 onwards, registered liens on aircraft;

- the covered bonds bank needs to establish a ‘cover register’ (*Deckungsregister*) for the relevant type of bond (ie ship mortgage bond or covered aircraft bond) to reflect the cover;
- each credit and its security as the ‘cover value’ will be entered into the cover register – all the credits and their securities of one bank in the cover register are collectively referred to as the ‘cover pool’; and
- to ensure the creditworthiness of the cover pool, the securities will be checked for their ‘mortgage lending value’, following mandatory strict valuation rules.

German covered aircraft bonds overview

Because it follows existing parallels, the amendment for covered aircraft bonds complies to a large extent with the regulations for ship mortgage bonds. For ship mortgage bonds, the hedging instrument is the ship mortgage; the equivalent for covered aircraft bonds is a registered lien on aircraft. This registered lien is unpropertied and requires an entry in the register for liens on aircraft (*Registerpfandrecht*). Parallels to ship mortgage bonds are:

- the object of hypothecation (section 26b, paragraph 1): only registered passenger or freighter commercial aircraft may be hypothecated;
- the limit of hypothecation (section 26b, paragraph 2): it must not be more than 60 per cent of the stated (and International Society of Transport Aircraft Trading-appraised) value of the object;
- the duration of hypothecation (section 26b, paragraph 3): it must not exceed the age of 20 years of the respective object. For the ship mortgage bonds, the age limit will be raised from 15 to 20 years accordingly;
- aircraft that are registered in foreign jurisdictions (section 26b, paragraph 4): their hypothecation is admissible if the foreign jurisdiction provides for comparable registered liens and its enforcement is admissible for foreign creditors;
- extent of cover (section 26b, paragraph 5): the cover of the covered aircraft bond extends to all claims of the bank regarding the economic substance of the aircraft, including insurance claims, returns, shares in property companies and bonds thereof (for the ship mortgage bonds, a corresponding provision will be amended in section 22, paragraph 6);

- the insurance (section 26c): the relevant aircraft must be insured for the entire duration of the hypothecation up to the amount of 110 per cent of the outstanding loan (for the ship mortgage bonds, the amount will be lowered from 120 to 110 per cent accordingly); this level of security means that about 40 per cent of the insurers may be in default without affecting the payment needed for the bond holders;
- cover (section 26d, paragraph 2): the value of the bonds issued must have cover of at least the same value or, alternatively, by certain comparable securities, such as secured debt obligations; and
- repayment (section 26e): repayment must not be postponed for more than two years. An extension of up to five years is subject to approval by *BaFin*.

Further to these parallels, the provisions on German covered aircraft bonds will have certain special characteristics. These are as follows:

- aircraft engines: section 26b, paragraph 2 requires the covered aircraft bonds to cover the aircraft engines. This also applies to aircraft registered in foreign jurisdictions. From a legal point of view, aircraft and engines are not considered as substantially one object and they may be separated permanently in the course of inspections, but this is not seen as an obstacle. This is due to the assumption that both aircraft and engines have registration numbers and could therefore be re-assembled, if required, as has been practised in the past. Another possibility would be to agree on a contractual obligation not to separate aircraft and engine permanently;
- change of registration: section 26b, paragraph 2 states that the aircraft can be registered in a new jurisdiction but such jurisdiction shall meet the above-mentioned legal minimum standards; and
- a registered lien under a foreign jurisdiction must fulfil the legal requirements of the Covered Bonds Code (ie right in rem on aircraft, entry in a public register, prior ranking satisfaction for the object).

Further comments on the amendment

- As recently established for the ship mortgage bonds, a statutory regulation for the valuation of aircraft (*Flugzeugbeleihungswert-Verordnung*) must be enacted (section 26d, paragraph 3).

- The regulations will be eased for consortial financing primarily aimed at smaller banks (section 5, paragraph 1, lit. a), achieved through simplified refinancing with the issue of bonds. It is necessary for the individual shares to be clearly defined.
- In the case of the bank's insolvency, the assets may be liquidated through the implementation of a refinancing register (section 30, paragraph 2). So far, there has been no regulatory basis for liquidation.
- In the case of the bank's insolvency, the solicitor appointed by *BaFin* shall have sole power of representation and management over the relevant assets (section 30, paragraph 3). So far, this power has remained with the board of directors.

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