

# Flexibility, Security and Efficiency of Security Rights over Real Property in Europe

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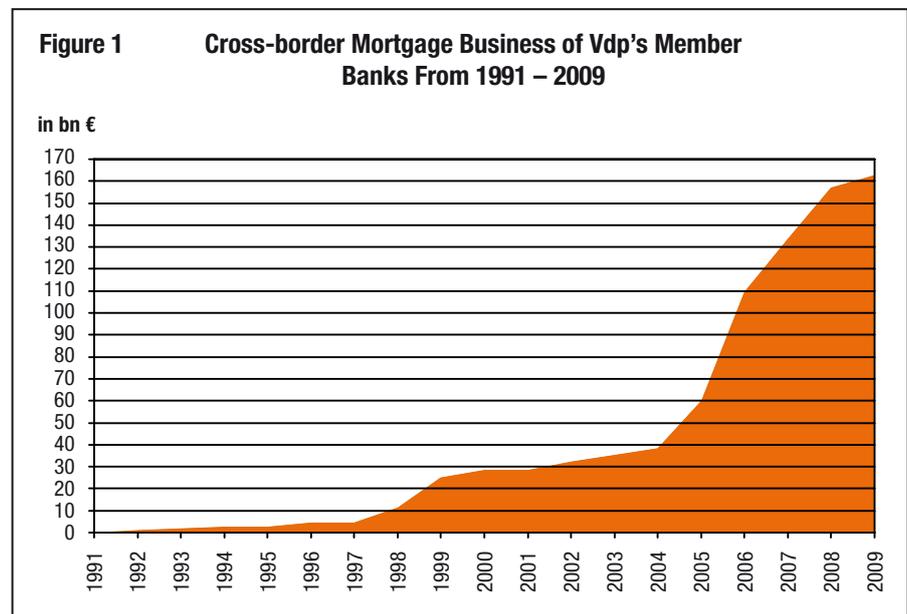
## 1. Need for comparative law information

Comparative law accounts of the law on security rights over real property in Europe are rare. Some detailed investigations are targeted at dealing with considerations concerning a Eurohypothec and for this purpose describe only a few mortgage law systems. The studies by the European Mortgage Federation overwhelmingly offer only a superficial overview or merely address some individual aspects in more detailed form. Other works apply only to individual countries or provide a broad picture in the context of a description of the law of property in the form of national reports.

The need for studies into mortgage law is, however, more urgent than ever.

### 1.1 Business

In recent years the need for reports on the law of mortgages covering several countries or even covering all of Europe has sharply increased. The reasons for this lie partly in the increasing cross-border mortgage business in Europe, which can be seen with the respective volume of vdp's member banks (see chart), which developed from 55,6 million. (1991) to 163 billion Euro (2009). The result of this is that a growing number of people are having to deal with the associated legal questions and the need for getting up to speed quickly with a different legal system is growing. Comparative reports and overviews make this easier. In addition, the involvement of foreign legal systems in the credit process and, moreover, particularly in risk management, inevitably results in individual credit institutions having to develop



assessment procedures in order to evaluate the different regulations. Banking groups that operate on a pan-European basis also have to deal with the legal systems of several countries in relation to risk management and group-wide risk weighting rules.

### 1.2 Demand because of risk weighting under the requirements of banking law

Stable credit institutions are an essential prerequisite for a functioning national economy and for a modern national economic system. Both the individual state and the international community therefore have a great interest in the stability of

the banking system. Consequently, individual states and supranational organisations develop statutory regulations or other sets of rules that are intended to ensure the stability of the banking industry. An important cornerstone is a system of banking supervision with a risk-sensitive focus. Particularly important in this regard is the fixing of limits up to which banks are permitted to undertake risks. In relation to loans, the risk profile is dependent, among other things, on the type and soundness of the loan collateral, and in relation to property loans, particularly on the quality of security rights over real property.

Of key importance for banks in Europe is how Basel II has been implemented in European law and then in national law. The relevant EU Capital Requirements Directive<sup>2</sup> specifies in Annex VI

The latest data on a country by country basis is shown in Association of German Pfandbrief Banks, Annual Report 2009, p. 34.

<sup>2</sup> Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, Official Journal of the European Union of 30.6.2006, L 177/1 et seq.

Number 48. c) and Number 54. c), in each case in conjunction with Annex VIII Part 2 Number 8<sup>3</sup> that a reduction of capital requirements on the basis of real estate collateral is only possible if the mortgage is enforceable and this enforceability has been legally verified. In addition the credit institution must be in a position to be able to realise the value of the mortgage within a reasonable period of time. These requirements apply both in relation to the standardised approach and the internal ratings-based approach.

For banks that operate in several countries, and all the more so for international banking groups, this means that loan collateral must undergo a risk analysis that they use to mitigate risk and thereby reduce capital backing. In order to bring real estate collateral into one uniform risk assessment system, an evaluation system that could be used to assess loan collateral on a transnational basis would seem to be desirable.

An assessment system for mortgages has not yet been publicly discussed. Solely, in 2005 the rating agency Moody's issued what was merely an overview in which it estimated the recovery rates for several European countries ("key jurisdictions"), largely on the basis of a short analysis of the legal framework and rather less on the basis of statistical data, such data being then (and now) not sufficiently available.<sup>4</sup> The resulting classification is very simplified but it does, however, at least show the usefulness of a qualitative comparative law analysis, particularly if statistical data is lacking. These findings should be taken into account in further deliberations concerning a legal assessment system.

Against this background, it was important for HypRating<sup>5</sup>, having offered to their customers recovery rates for Germany since 2002, to find solutions for foreign countries. Although HypRating was able to appraise recovery rates for several countries based on statistical data, it will take a long time to draft a full picture over recovery rates in all relevant countries. This is why HypRating has made the findings of the Round Table<sup>6</sup> the base of their considerations to assess recovery rates founded on comparative law.

## 1.3 Crisis

Since the crisis in financial markets triggered by the subprime mortgage crisis, if not earlier, the degree of transparency required of structures within the capital and banking markets has generally increased. Professionals who deal with several legal systems in the course of their international mortgage business have, time and again, articulated their need for clearly set out descriptions of the law of property.

Sometimes astonishing and even shocking news was spread worldwide on how enforcement of mortgages is performed – and no information, at least none easy to understand, was available to show legal and practical facts of the relevant country in comparison to others.

## 1.4 Legislation

For several years in many countries, primarily in Central and Eastern Europe, the civil law systems as a whole have been subjected to scrutiny and have undergone far-reaching modernisation; mortgages figure highly here and the experts involved are very interested in transnational exchanges of opinion and experience. In Western Europe too the law of security rights over real property has been amended and supplemented in many countries, e.g. by the introduction of the "hypothèque pour toutes sommes" in Belgium (1996)<sup>7</sup>, the "hypothèque rechargeable" in France (2007)<sup>8</sup> and by expansion of the scope of application of the "hipoteca de máximo" in Spain (2007)<sup>9</sup>. All three changes have been in the direction of greater flexibility in countries in which mortgages had hitherto been among the least flexible.

The White Paper on Mortgage Credit aims to increase the efficiency of mortgage markets. To this end it also deals with the duration of land registration and compulsory enforcement proceedings.<sup>10</sup> Protection of the owner or consumer in enforcement proceedings is not taken into consideration. This is all the more astonishing as the White Paper in other respects prioritises consumer protection issues. In the meantime, based on the White Paper, in 2008 the EU Commission

began to prepare a Recommendation on real estate valuation, enforcement proceedings and registration. Influenced by the impact of the financial crisis, the EU Commission postponed the publication of its recommendation, thus changing its course increasingly considering aspects of debtor protection. In this context the EU Commission is now working on a report on measures to hinder enforcement proceedings. This narrow perspective, putting emphasis on debtors' interest only, does not seem to be adequate to deal with the complex legal issues of debtor and owner protection with mortgage loans.

Furthermore works have started to put all responsibility of any problem with mortgage loans on the shoulders of the creditor via introducing regulations on "responsible lending".

## 2. Round Table on flexibility of mortgages

The vdp has set itself the goal of contributing to transparency in the law on mortgages in Europe, not only in the form of publications relating to specific countries, but also by developing transnational slides that facilitate rapid access to detailed information and legal facts. It was for this purpose that the so-called "Round Table: Flexibility of security rights over real property in Europe" was established, in which mortgage collateral specialists from 24 countries are now involved.<sup>11</sup> Since 2005, 8 workshops have taken place, each one lasting 2 full days.

The aim of the Round Table is to provide legal information in form of country charts in colour showing Europe (and Japan) as an overview and answering questions in an easy-to-understand way. The whole series of slides was first published in 2009 – in German<sup>12</sup> and in English translation.<sup>13</sup> Alongside their function as an information source, publications also have important significance for the credibility of an assertion or an analysis because they are open to review by a specialist audience, unlike secret legal opinions about complex capital market instruments, which cannot be the subject of broad, academic review.

<sup>3</sup> Capital Requirements Directive, Annex VIII Part 2 Number 8: "For the recognition of real estate collateral the following conditions shall be met: a) Legal certainty – The mortgage or charge shall be enforceable in all jurisdictions that are relevant at the time of the conclusion of the credit agreement, and the mortgage or charge shall be properly filed on a timely basis. The arrangements shall reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall have been fulfilled). The protection agreement and the process underpinning it shall enable the credit institution to realise the value of the protection within a reasonable time frame. b) Monitoring of property values..."

<sup>4</sup> Cf. *Moody's European Country Tiering for CMBS Recovery Rate Assumptions: Focus on Key Jurisdictions*.

<sup>5</sup> Hyp Real Estate Rating Services GmbH is a subsidiary of Verband deutscher Pfandbriefbanken e.V.

<sup>6</sup> See section 2.

<sup>7</sup> See *Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, 2<sup>nd</sup> revised and extended edition, Berlin 2010 (vdp's publication series, Volume 39), p. 48.*

<sup>8</sup> See *Gourio, L'hypothèque rechargeable, Revue de droit bancaire et financier, No 9/10 2006, pp. 39; Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, 2<sup>nd</sup> revised and extended edition, Berlin 2010 (vdp's publication series, Volume 39), p. 23.*

<sup>9</sup> The Spanish hipoteca de máximo is examined in a thesis by *Hector Simón Moreno* on the harmonisation of mortgage law in Europe, which will be published in the near future.

<sup>10</sup> *European Commission, White Paper on the Integration of EU Mortgage Credit Markets, Brussels, 18.12.2007, 4.2.*

<sup>11</sup> 13 national reports and a series of comparative law slides by authors from this expert group have already been published in volumes 23 and 32 of the vdp's publication series.

<sup>12</sup> *Stöcker/Stürmer, Flexibilität, Sicherheit und Effizienz der Grundpfandrechte in Europa, Band III, Berlin 2008 (vdp's publication series, Volume 37).*

<sup>13</sup> *Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, Berlin 2009 (vdp's publication series, Volume 39).*

The first edition (volume 37/39) contained a substantial series of slides, displaying a comparative description of the law of security rights over real property for 22 jurisdictions with explanations of the individual questions and answers. On this basis, in two additional workshops of the Round Table in March and November 2009 in Berlin, an assessment process could be developed, generally and for specific business perspectives. This process and its results are published in volume 43 (in German)<sup>14</sup> and 44 (in English)<sup>15</sup>. In this second edition the number of analysed jurisdictions increases to 24. The Vdp is prepared to foster materially scholarly-based development of such evaluation procedures also in future. For this, co-operation with scholars in Sweden and other European countries was initiated with the objective to integrate more jurisdictions into the work of the Round Table.

### 3. Methodology

Procedures for assessing legal structures require, in the first place, a detailed description of the different legal systems in accordance with a standard base model. To develop this is a major challenge.

On the one hand, the questions asked must be worded so generally that they are meaningful for all the legal systems involved. On the other hand, the degree of detailed analysis must be as high as possible in order that the strengths and weaknesses of the individual legal systems can be truly understood – and all the while taking careful account of the framework conditions of individual business models or types of business. Thus, different legal questions are to some extent relevant in the case of private housing finance than in the case in relation to commercial property loans.

#### 3.1 Charts on questions & answers

The commentary on the slides about the law of mortgages is divided into seven subject areas.

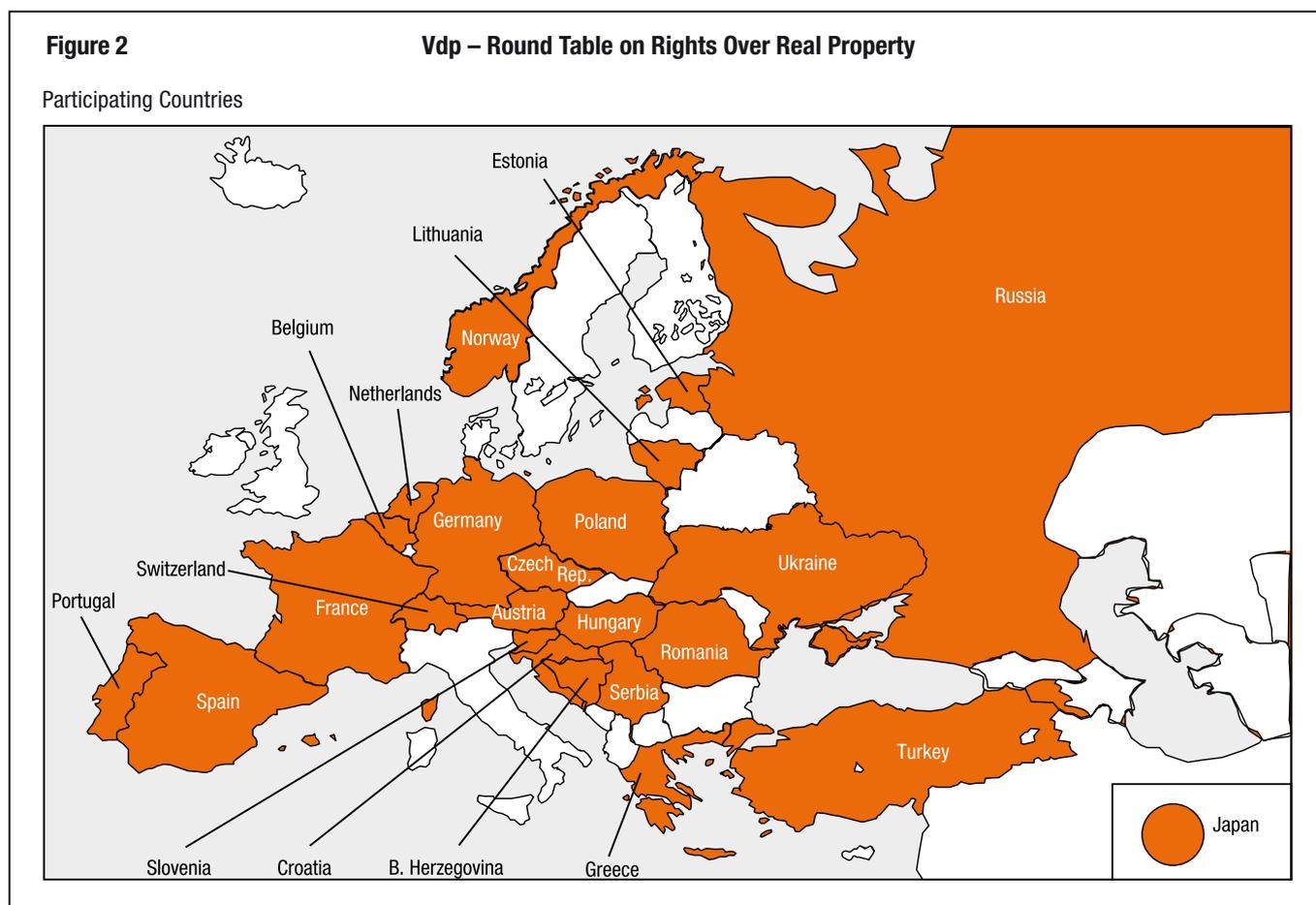
Following some basic remarks on types of mortgages (I.), central issues regarding register systems, and how they bring about the requirements of public disclosure for mortgages, are addressed (II.).

The discussion of the effects of accessoriness (III.) draws as many distinctions as possible in order to counteract the normally encountered

black and white classification into accessory and non-accessory mortgages which frequently leads to misconceptions, particularly in regard to protection of the owner. A separate chapter is therefore devoted to this issue (IV.), which is, incidentally, of the greatest importance, not only for consumers, but also generally, for every owner of mortgaged property, and it is therefore dealt with comprehensively, the consumer aspect included.

Security rights over real property are used to secure payment debts and they must prove their worth if the debtor is no longer able to pay. The “legal solidity” of a mortgage in the context of enforcement proceedings (V.) and insolvency proceedings (VI.) is thus of key importance for credit practice. The numerous slides dealing with these issues take account of this.

The questions covering the subject areas mentioned above, which are of practical importance but still geared towards legal theory, are supplemented with a chapter dealing with the practical application of mortgages (VII.) in some important business cases.



<sup>14</sup> *Stöcker/Stürmer, Flexibilität, Sicherheit und Effizienz der Grundpfandrechte in Europa, Band III, 2. erweiterte Auflage, Berlin 2008 (vdp's publication series, Volume 43)*

<sup>15</sup> *Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, 2<sup>nd</sup> revised and extended edition, Berlin 2010 (vdp's publication series, Volume 44).*

The work of the Round Table, even at this stage, has already attracted the attention of banking practice, as documented by the use of the results by HypRating. Also academics are beginning to discuss the issues of the Round Table.

### 3.2 Assessment system for mortgages

Another focus of the study is put on a more detailed description of a possible assessment system for the legal framework for mortgages in Continental Europe. It is intended to offer an initial overview as to how the “legal soundness” of security rights over real property could be comparatively “measured” in a general or a bank-specific manner, or in accordance with the particular type of business. It does, however, not claim to be a fully developed econometric international comparison.

Volume 43/44 does not only document the approach to the development of the assessment system, but also the details of the weighting and assessment ratios as well as the results of the assessment in form of bar graphs.

#### 3.2.1. Assessment procedure

The various slides contain many questions on many countries. In order to reach a comparative law conclusion, in the sense of an assessment, it was beneficial to generate a rating score per country at the end of the assessment process.

To achieve this, the legal conclusions of the slides had to be brought into a points system. For this purpose the various answers from the individual slides had to be weighted, and also the individual questions in relation to each other.

The weighting of the questions were geared to the significance of a question for the overall assessment, so according to how important the individual question is based on a balanced consideration of the various interests that have to be taken into account (bank risk, cost of credit, consumer and owner protection etc.). The weighting of the answers to any one question depended on how good or bad the outcome of the individual answers were; this in turn also had to be judged on the basis of various interests.

Questions and answers that are judged to be neutral or of the same value were given a weighting of 0 or receive the same number of points. They were not, however, removed from the series of slides as they could be extremely important for understanding the legal interconnections.

In the final stage the weighted scores per country were added together to produce the rating

score and this was then compared with the rating scores of the other countries.

Processes of this type to quantify quality are presently very common in many areas for establishing rankings. If the process is carried out with the maximum care and diversified weighting, useful conclusions are reasonably possible. Such findings should not, however, be rendered in absolute terms; the quantification of quality has too many fundamental weaknesses for that. When making decisions about taking on financing, it is above all advisable to avoid a rigid schematic approach without pragmatic reconsideration of the details of the individual case.

#### 3.2.2 Importance of business model and business structure

Abstract theoretical judgments about the “mortgage law” of a country are problematic for the purpose of risk assessment by banks as all legal systems permit many versions of security by mortgage, and most of them also have available several types of security right over real property. Thus any simplification inevitably leads to a gross distortion.

A more targeted approach is to examine the security quality of mortgages in terms of the specific security quality of business models and specific business structures, because the particular features of these have consequences for the contract and collateral structure. These business models may be different with every bank. Using these business models, the slides are then chosen that are actually relevant in the individual case, and this applies likewise for the individual answers to the various slides.

This institution-specific approach corresponds to the objectives of Basel II which aims to achieve high quality supervision that is specifically geared to the specific business structures of a bank. An assessment system for mortgages conforming to this directional approach is much more telling for the risk situation of security rights over real property that are actually used by a bank than an abstract, theoretical cross-section appraisal of many countries that by its nature must remain imprecise and superficial.

Example: in relation to commercial property financing via SPVs

- preferential rights for employees are not relevant, but are very relevant in relation to direct company financing and in particular in relation to working capital finance;
- preferential rights for persons entitled to alimonies can be disregarded, but not in relation to residential financing.

Thus, in relation to the business model for commercial property financing via SPVs, preferential rights of these types may also be left out of consideration in countries that in principle recognise such rights in enforcement and insolvency.

#### 3.2.3 Different perspectives

Alongside the evaluation of mortgages from the point of view of banks, i.e. mortgage creditors, other perspectives should, however, also be taken into consideration, namely the perspective of the debtor/owner whose protection against unjustified enforcement proceedings merits attention and the perspective of the legislature, which has to create a balanced overall system and to do this has to set priorities.

Evaluation of the legal quality of security rights over real property from these different perspectives sometimes leads to questioning of different priorities than if matters are considered solely from the point of view of a bank. But even for a bank the questions differ in significance depending on whether it only examines the prospects of realising a mortgage that already exists or whether it also wishes to evaluate the extent to which a security right over real property can and is to be used to secure a credit structure that is capable of being established in the market. For an overall complete assessment, political stability of the legal system may be of much significance, too.

In its advisory role the vdp has for a long time recommended that a balanced overall system should be the objective because it is only in this way that a long-term stable legal framework can be established. Regulations that strongly and unilaterally favour the mortgagee run the risk of being corrected sooner or later by case law or legislation. They are, at the end of the day, also unsuitable for safeguarding long-term market opportunities.

## 4. Findings of the Round Table in cooperation with HypRating

The results obtained to date have shown that in many countries where mortgages have an accessory structure. The type of security right primarily used is the maximum amount hypothec; here the accessoriness of scope is relaxed, because the secured claim can fluctuate in terms of amount without need to change the amount of the security right over real property. This has, to some extent, a very high level of flexibility, but only as long as the owner and creditor do not change. An in-depth academic reappraisal of mortgages in Europe from a comparative law perspective will not be completed for a long time yet. There is a great need for comparative law investigations

into the structural linking of loan agreement and creation of the mortgage, the issue of allocation of the burden of proof, as well as acquisition in good faith and the use of unconditional promises of payment. The financial crisis confirmed the previously initiated strategy to add special chapters covering enforcement law and insolvency law.

The attachment, published in volume 43/44, gives detailed description of the findings of the Round Table in the two workshops of March and November 2009.

On the one hand, the Round Table could agree on weighting ratios to each question and answer, thereby evaluating each question and answer from four different perspectives:

- perspective of a bank, who has to exploit a security right over real property (bank / enforcement),
- perspective of a bank, using a security right over real property to secure loans (bank / usability),
- perspective of an owner facing enforcement of his real property (owner) and
- perspective of a legislator, who wants to consider diverging interests of all parties adequately (legislator).

On the other hand, findings are published, which are derived from the combination of those weighting ratios with the individual country information. For this, in a first step all 89 questions are considered for calculation. This results in the following categories of findings:

- Complete findings – perspective of enforcement
- Complete findings – perspective of usability
- Complete findings – perspective of the owner
- Complete findings – perspective of the legislator
- Complete findings – total addition of all scores (see Figure 3)

In a second step, only the questions of the chapters VI. and VII. are considered in order to limit the analysis to problems of enforcement and insolvency law; issues of flexibility of the security rights over real property are not taken into consideration in this version of the findings in order to prevent possible criticism that the complete results would favour non-accessory security rights over real property. This leads to the following categories of findings:

- Partial findings enforcement and insolvency – perspective of enforcement
- Partial findings enforcement and insolvency – perspective of usability
- Partial findings enforcement and insolvency – perspective of the owner
- Partial findings enforcement and insolvency – perspective of the legislator

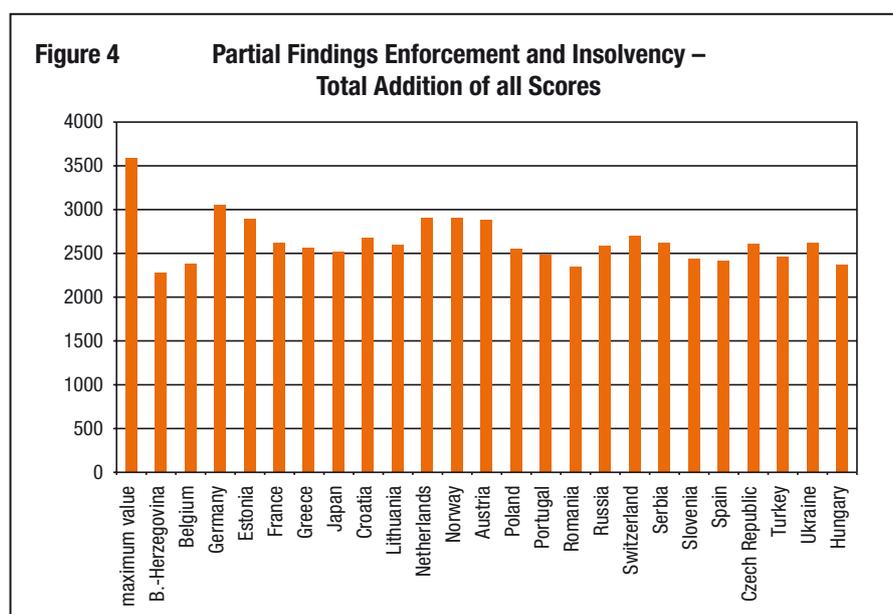
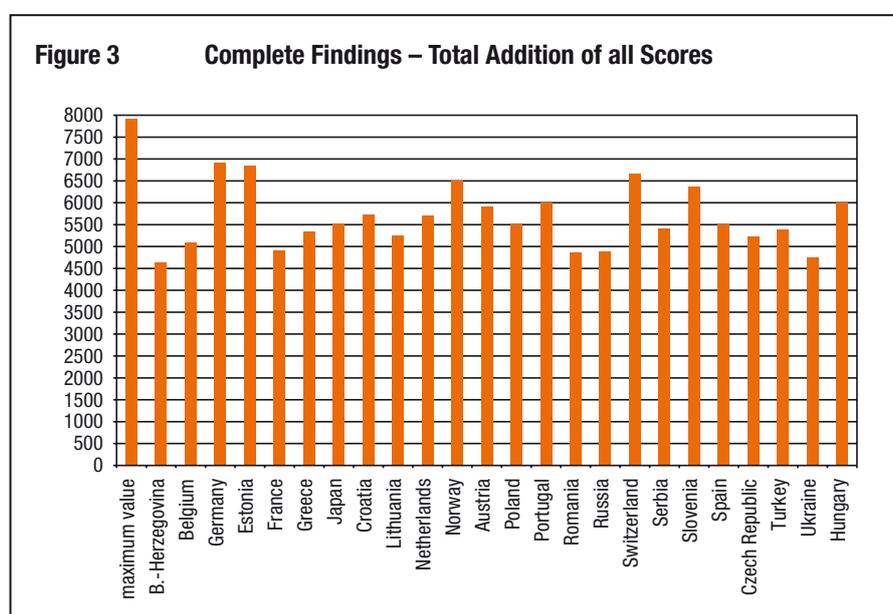
- Partial findings enforcement and insolvency – total addition of all scores (see Figure 4)

The publication of all these details is designed to make the method and performance of the analysis more comprehensible. However, it would be beyond the limits of the book to give a detailed full description of the intense discussions of the Round Table and the reflections that resulted in the particular assessment of each ratio.

The technical calculation of the results was done by HypRating. It turned out that HypRating can use the findings of the Round Table very well, because this assessment system grants a high grade of

transparency and is updated regularly. Moreover, its extension to further countries is possible.

Hard copies of the vdp publication series including the book presented here can be obtained free of charge from the vdp via the order centre on vdp's website. As soon as hard copies are out of print, the publication will be made accessible via downloading from vdp's website.



<sup>16</sup> [http://www.pfandbrief.de/cms/\\_internet.nsf/tindex/en\\_66.htm](http://www.pfandbrief.de/cms/_internet.nsf/tindex/en_66.htm)