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Credit Purchase and Risk Transfer in Germany

A review

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1. Legal basis

The fact that credits or loans can be sold and traded seems like an unusual idea to people who are not familiar with this specialized subject. From the perspective of both credit institutions and consumers, a loan agreement is based on a relationship of trust, at least according to German philosophy. The fact that one party, the credit institution, can extricate itself from this relationship of trust by “selling” the loan without the consent of the other party and can impose a new creditor on the loan borrower has seemed and still seems to many observers to be an unreasonable and unilateral preference for one party to the contract. Thus, there was and is to this day an intensive, but recently diminishing, debate about the intrinsic justification and politically intended permissibility of the sale of loans as an instrument of the German legal system.

German law defines the sale of a loan as the assignment of the creditor’s position in the loan relationship in return for payment. The decisive factor in this context is the enabling of the complete assignment of creditor rights to a third party who becomes the creditor without the debtor’s consent, and in fact, often initially without the debtor’s knowledge.

This provision of the German Civil Code, the BGB of January 1, 1900, was the solution that had been reached at the end of a long controversy. Thus, in the run-up to the creation of the BGB, the German legal system had decided, after a hard struggle, against the idea of debtor protection and in favor of the principle of marketability, and thus, the fungibility of claims as an asset. Thus, the idea of the free transferability of claims was implemented to a very large extent: every debtor of a claim thus had to accept the disadvantage of obtaining a potentially more rigorous creditor by way of assignment. However, the debtor can raise the same objections against the new creditor that he had raised against the old creditor. This legal situation, which has applied since the creation of the German Civil Code, continues to apply unchanged today.

2. Development 2000 - 2008

Up to the turn of the last century, there was apparently little reason to discuss this legal situation to any great extent in the German financial market. This changed dramatically in the eight years following the turn of the last century. During this period, German banks sold a loan volume of € 35-40 billion to institutional investors, such as hedge funds, private equity companies and investment banks. The loans, which were always sold in packages, were mainly non-performing and sub-performing loans. Performing loans were added to refresh their quality. The loans were sold at a discount on the nominal values of the loan packages. The reason for this wave of sales was generally to be found in the difficult balance sheet situation of the banks at that time, which was also due to the economic situation, but above all, was due to the measures taken by the banks to prepare for the new equity capital regime to be imposed on them under the Basel II Accord.

This development did not go unnoticed by the public. The press reported rigorous coercive measures taken by loan buyers against borrowers, even those who had allegedly been repaying their loans according to their contracts. Public television ran the headline: “Unscrupulous businesses: how locusts rip off homeowners in Germany.” *Der Spiegel* ran a full-page report on the fate of savings bank customers who found themselves in the hands of greedy and rigorous hedge fund creditors. At the height of the campaign, the president of the German savings bank organization had to defend himself and make amends on a talk show that was seen by millions of viewers - quite an unthinkable situation for the president of a savings bank. The sale of loans as an instrument seemed permanently torched.

The development of the US market was seen as confirmation of this negative assessment of the sale of loans. Unlike the German market, the US market did not have this fundamental understanding of the relationship of trust between lender and borrower. According to the Anglo-Saxon understanding, the fungibility of a loan was a necessary element of a functioning financial system. However, around 2004, a development began in the United States regarding the possible use of this element that would soon defy the imagination. Fueled by sales, bonus and commission systems, US retail banks began to launch credit programs on an immense scale with interest rates that were initially favorable, which they sold into the investment market immediately after the conclusion of the contract, thus reaping the discounted interest margin. In such a system, the creditworthiness of the individual debtor no longer played a role. Retail bank loan packages were snatched up by investors. Because there wasn’t enough material, they eventually switched to issuing hybrid loan packages, which were nothing more than bets on the mortgage market. The result was a credit and speculation bubble of immense proportions that shook the world financial system.

The German financial market was particularly affected by these developments. More generally, of course, there was a lemming effect, with the consequence that both private and public-sector institutions rushed into the seemingly high-yield and booming US mortgage market. But there was another disastrous development.

The German public-sector regional banks had lost the privilege of government guarantees after a heated dispute with the private banks at the EU level. For a temporary period only, they were still allowed to borrow funds using government guarantees, which had the famous AAA rating and thus extremely low interest charges. These funds were now waiting to be invested. The investment pressure on the regional banks was enormous, and so these funds essentially flowed into the US mortgage market in subprime risks. After the bubble burst, the regional bank system was shaken and the largest regional bank, WestLB, did not survive this shakeup.

3. The Risk Limitation Act of 2008

At the beginning of 2008, the abuses and undesirable developments in the financial markets were obvious. The financial system was at risk, the public was agitated and political action was inevitable.

It was clear that the dogmatic root cause and lever for the different but interrelated undesirable developments was the fungibility of credit, i.e., the possibility of assignment without the debtor's consent. It was this possibility that catapulted the trust-based credit relationship into an available, depersonalized commodity. The question now was: were all these undesirable developments based on an abuse of a legal institution - an abuse that could be contained and tamed by regulation, or was the very essence of the basic legal construction itself wrong - and was there thus a need for the material exclusion of assignments altogether. For the first time since the German Civil Code entered into force, this old question from the last third of the 19th century was now back on the agenda in full force.

It is clear that the consumer advisors and public relations officers of the political parties advocated the latter alternative. They called for a strict prohibition of assignment or for the mandatory requirement of consent by the debtor. Politically, however, the other side prevailed. The "Risk Limitation Act" of August 2008 continued to allow the sale of loans and thus allowed the assignment of the creditor's position without the debtor's consent, but combined this with a series of notification obligations and formal requirements aimed at protecting consumers. Thus, in principle, the decision had been made: lawmakers clearly upheld the principle of the fungibility of credit at a critical moment. The political debate had thus been decided.

The main justification for maintaining the status quo of the old BGB solution was, of course, put forward by the financial experts of the parliamentary groups, and also by the representatives of the financial institutions, such as the German Federal Financial Supervisory Agency (BaFin) and its international partners: any exclusion, and also any substantial material restriction of the fungibility of credit would lead to massive limitations on the ability of individual institutions, as well as the financial supervisory authorities, to react in times of crisis. If the largest or even the nearly exclusive assets of a credit institution were not disposable in times of crisis, the credit institution in crisis was doomed and there was a high risk of contagion for the entire market, given the powerlessness of those involved. Such a solution would be economically irresponsible. This is why politicians have decided to take this path. However, they have installed numerous stricter regulations to prevent abuses.

4. The practice after 2008

This is not the place to describe the crisis-like escalation of the global financial system at the turn of 2008/2009. What is clear is that the German and European financial and banking systems were also on the verge of collapse and could only be rescued by far-reaching, internationally coordinated government interventions and guarantees. The equity base of credit institutions had eroded, so that, to the extent that banks were considered viable, it was necessary to spin off large loan portfolios to “bad banks.” At the same time, financial assistance was provided by the government-owned special financial market stabilization funds (SoFFins). In legal terms, all these spin-off measures were sales of loans, which had to be carried out on a large scale with government support, but without any involvement by the debtors. It was not until later that the sale of loan portfolios on the private market was considered again in order to relieve equity.
They were not to become an instrument of the markets again until 2012, i.e., at a time when the government began to withdraw from its supporting role. What was and is undeniable, however, is the realization that it was only through the fungibility of credit, i.e., through the legal institution of the assignment of the creditor’s claim rights under the loan agreement, that the crisis could be managed at all - regardless of the market failure described above in the implementation of this policy in the further course. The assessment of policymakers in the run-up to the Risk Limitation Act that the principle of fungibility should be upheld was therefore correct.

However, the discontinuation of government support now had serious consequences. This was because all the balance sheets of all the banks had by no means been cleaned up, which meant that these institutions had to rely exclusively on the private market. However, this market was now tighter than it was before the crisis. It now became obvious how indeed narrow and oligopolistic the demand side of the market for credit risks was structured - and it has remained so to this day. In view of the large volumes of credit traded, only a few financial institutions such as US investment banks and large hedge funds with the necessary expertise and financial resources were (and still are) eligible to buy credit risks.

This narrowness of the market on the buyer side enables buyers to determine prices. The fact that the sales processes themselves are extremely complex and require a high level of expertise also plays a role - as a rule, the data and credit documents are made available to interested parties for inspection and review over a period of several months. Thus, the lack of a sufficiently large number of potential buyers, the complex procedure itself, and a remarkable lack of transparency, which inevitably results in high information asymmetries, led to considerable discounts on the nominal values of the claims sold. In addition, intermediaries, lawyers and consultants incurred high transformation costs.

In summarising these developments, the following should be noted: the principle of the fungibility of credit claims is anchored de jure in the German Civil Code and can help in times of crisis when the government acts as a buyer, either directly or in disguised form. When not in times of crisis, however, high hurdles exist in the normal private market, which ultimately amount to a market failure - this was also the finding of the Commission and the European Banking Authority.

5. A milestone: the establishment of a credit platform for the German market and its failure in the 2009 financial crisis

The authors of this paper believe that there is only one sensible solution under public law for a transparent, neutral and controlled way to remedy the aforementioned market failure and to transfer credit risks in a market economy: by establishing an electronic trading platform for loans in the form of a public stock exchange. The authors are convinced that this can only be done in a uniform manner at the European level. National solutions would at best be interim solutions, subject to replacement by an EU model.

To implement this path, the authors have developed a project under the name “P4C - Platform for Credits.” Information on this can be found in the study “The Fungibility of Credit - Key to a Deepened European Economic Order.” It is important to note that such a credit platform with an associated stock exchange has already existed in Germany. The P4C model is therefore based on a platform which has already been implemented, a predecessor model, which was launched on the market on January 1, 2009 after a seven-year development period - **with BaFin approval and formal authorization by the stock exchange supervisory authority** - but unfortunately, it was launched at the height of the financial crisis, which was the worst possible time. Because the private market for claim purchases had collapsed at that time - for more than three years - the company failed. So, timing is also crucial in the financial industry.

The genesis of the predecessor model began with an attempt to set up a commodity futures exchange in Hanover in 2001 and 2002 as a risk management tool for agricultural products. After this project was underutilized due to a lack of demand, a small group of actors came to the conclusion that it would make sense to set up an exchange for trading loans for risk management purposes in view of the increase in the sale of loans observed in the market. With the help of politicians, with significant support from the FDP Minister of Economics Walter Hirche, and against the explicit vote of the CDU Ministry of Finance, the business purpose of Warenterminbörsen-AG was thus expanded with the aim of developing an exchange for credit trading, known as Risk Management Exchange AG, or RMX AG.

This goal was achieved. After a development period lasting until 2009 and a total expenditure of approximately € 20 million, the competent regional supervisory authority granted the stock exchange license with the approval of BaFin. On January 1, 2009, RMX went to market. At that time, more than 50% of RMX AG was held by the State of Lower Saxony together with the public-law insurer VGH Versicherungen. The other shareholders included a diverse group of interested institutions and private individuals (Lehmann Brothers, the Deutsche Hypothekenbank and others). In organizational terms, the RMX team was essentially a spin-off of personnel from the Lower Saxony banking community. Well-known auditors had provided intensive support for the project.

So, after successful test runs with original loans, RMX AG went to market on January 1, 2009. The world’s first trading platform in the form of a public stock exchange, approved in accordance with the strict rules of the German financial supervisory authority and German stock exchange law, opened its doors - and nobody came.

Of course, there were (non-legally binding) commitments from a whole range of institutions that offered the prospect of placing substantial volumes - several billion in total - on the exchange, but this never happened. Later in 2009, RMX AG filed for insolvency and was liquidated.

Two reasons were decisive for this development. January 1, 2009, the day the platform was opened, was the absolute peak of the financial crisis that was shaking the world. The banking system was faced with the question of survival, the credit situation in the banks was judged according to whether and which government rescue solutions were necessary for survival and the purchase of non-performing loans by any private financial investors was completely unthinkable. It was also clear that, even with the provision of government purchase programs and bad bank solutions, the market would need a long time to return to normality. But normality was the prerequisite for the willingness of private market participants to invest in non-performing loans again.

It was therefore conceivable that, due to the combination of timing, a severe lean period of, from the point of view of the time, two to three years would have to be financed. Since the State of Lower Saxony was the main shareholder, its position on the matter was decisive. The German Ministry of Economics was strongly in favor of financing the lean period, above all, by the way, with the argument that, in the event of a return to normality and a withdrawal of the government from the aid measures it had initiated, the market would be in urgent need of the sale of loans as an instrument. After all, it was conceivable that there would be a need for balance sheet adjustments for a long time to come.

However, the Ministry of Finance prevailed and its opposition to the project from the very start was confirmed. RMX thus went into insolvency. The main creditor was none other than the Telekom subsidiary T-Systems, which had helped build and had pre-financed the technical aspect of the platform.

This story is also significant because it demonstrates that the concept of a trading platform for loans in the form of a public stock exchange is legally and technically **feasible and can be approved by the supervisory** authorities - a fact that should not be underestimated in view of this business model’s many skeptics.

6. The fungibility problem - unsolved to this day

Not to be dismissed out of hand, though it is basically philosophical in nature, is the consideration that the legal-technical vehicle of fungibility, which made the crisis possible in the first place, if not the cause of it, was thus also, conversely, a necessary precondition for the resolution of the crisis. But this is precisely what characterizes the relationship between the proper use and the abuse of a legal institution.

However, one must honestly admit that the instrument of fungibility helped to end the financial crisis only to the extent that government or government-supported instruments such as SoFFiN or bad banks were available to absorb the loans. Once these instruments ceased to exist, the market collapsed, and thus the German market is still dealing with the problems described under No. 3 above and addressed by the EU Commission in its mandate to the ECB: with market failures and monopolized supply structures. So far, there has been no discernible willingness on the part of politicians in Germany to remedy this situation by establishing a credit platform. Only time will tell whether this remains the case.

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