

Institutional Research Flash

White Paper No. 9

Swiss covered bonds: Investors' flight to quality

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Legal framework

The Swiss Pfandbrief system was given its present form by the Federal Pfandbrief Act in force since 1931 (Pfandbriefgesetz PFG), complemented by the Pfandbriefverordnung (Pfv). In contrast to other European countries, only two institutions are authorized to issue Pfandbriefe in Switzerland, namely the Pfandbriefzentrale der schweizerischen Kantonalbanken (the Pfandbrief institution for Swiss cantonal banks) and the Pfandbriefbank schweizerischer Hypothekarinstitute (the Pfandbrief institution acting for all other mortgage lenders in Switzerland). The scope of business activity at these two institutions is limited to the issuance of Swiss Pfandbriefe, the granting of Pfandbrief loans to their members as well as non-member banks against collateral ("specialized banking principle"), the investment of own assets and other short-term banking activities required to carry out the aforementioned tasks. Neither of the two institutions has a general banking license. Both institutions are supervised by the Swiss Federal Banking Commission. Swiss Pfandbriefe (literally: "letters of pledge") are in general standardized secured fixed-rate debt securities, collateralized by first lien mortgage loans. Maturities range from 2–20 years. Swiss Pfandbriefe are eligible as collateral for repo transactions with the Swiss National Bank.

Strict regulation

Swiss Pfandbriefe are subject to strict regulation. The maturity and repayment profile of a Swiss Pfandbrief must match that of the underlying collateralized mortgage loans to banks (balance and cover principles). This eliminates the duration and interest rate risks (no currency risk as cover assets and Swiss Pfandbriefe must be in CHF). Early repayment of loans is permissible only if Swiss Pfandbriefe of the same series are delivered in lieu of cash. The loans must be covered at all times with domestic pledged collateral, and any shortfall must

Highlights

- Swiss Pfandbriefe (Swiss covered bonds) are the second largest and most liquid segment on the Swiss domestic bond market after government bonds.
- Backed by a strong legal framework (amended only twice since 1931) and high-quality fundamentals, Swiss Pfandbriefe carry a Aaa-rating and are among the safest investments.
- Despite the overall increase in ASW spread levels since October 2008 following the worsening of the financial market turmoil, the spread levels of Swiss Pfandbriefe have remained on low levels compared to other covered bond markets or high quality issuers, illustrating the quality of Swiss Pfandbriefe.
- Swiss Pfandbriefe played a key role in stabilizing the Swiss banking system in 2008, helping to redistribute liquidity effectively at a time when increased counterparty risk brought money markets practically to a standstill.
- Swiss Pfandbriefe can hence be expected to continue playing their safe-haven role in the future and show tight asset swap spreads as a result.

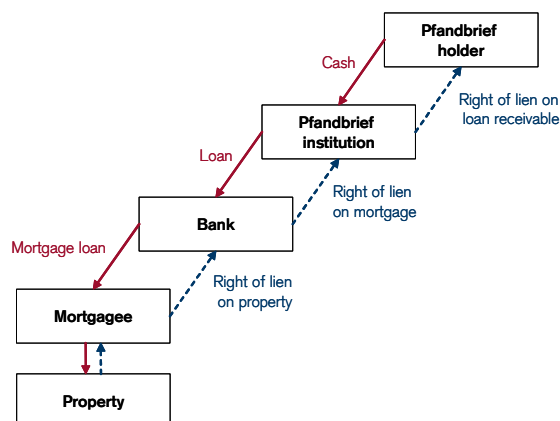
be compensated with mortgages (PfG would also allow cash or listed bonds issued by the federal government, cantons or municipalities with a haircut; however, this is not used in practice). The mortgages in the cover pool must be listed in a cover register ("Pfandregister"), but are still held and managed by the banks themselves (but monitored by the Pfandbrief institutions). This is in contrast to mortgage-backed securities, where, through securitization, mortgage loans are removed from a bank's balance sheet. The mortgages included in the cover pool must be physically separated from other mortgages. The Pfandbriefbank highlighted that it thoroughly checks the eligibility of cover assets in a multi-step approach. Further, banks are required by law to replace impaired assets in the cover pool and also to increase the collateral if the interest income on the underlying mortgages is below the interest expense on the loan.

Based on the PfG, eligible assets for the cover pool are mortgages on real estate and land (excluding property whose value diminishes with exploitation such as mines and quarries) and Swiss Pfandbriefe secured on aforementioned assets. In Switzerland, the cover pool is largely made up of residential properties, whose default rates are considerably lower than those for mortgages on commercial properties. The maximum statutory loan-to-mortgageable value ratio is 2/3 applied on conservatively calculated underlying values (fair market value or "Verkehrswert" for residential property; capitalized earnings value or "Ertragswert" for multifamily homes). For all other real estate, the loan-to-mortgageable value ratio is 1/2. Further, mortgages in the cover pool are spread across Switzerland, which largely eliminates geographical cluster risk. On top of the already cautiously calculated cover assets, the two Pfandbrief institutions also require a higher degree of over-collateralization (OC) than required by law (PfG: 0% OC). At the Pfandbriefbank, pledged eligible mortgages must exceed the amount of loans by 3%, while the Pfandbriefzentrale requires 10% OC for member loans. This OC is relatively high, in our view, considering the fact that mortgages are repaid partly over time while the value of the pledged title remains unchanged and the property value increases.

High security for Swiss Pfandbrief investors

Swiss Pfandbrief investors benefit from a chain of safety provisions, whereby obligations arising from Pfandbrief loans are backed not only by the underlying real estate mortgages (see Figure 1), but also by the mortgagee, the member banks with all their assets, and the Pfandbrief institution itself. Should a debtor bank of a Pfandbrief institution become insolvent, Swiss Pfandbrief investors and the Pfandbrief institution would have a direct preferential claim on the registered collateral backing the loan ("bankruptcy remoteness"), while other creditors could only lay claim to the cover pool once the claims of the Swiss Pfandbrief creditors were satisfied in full. As banks are required to redress insufficient collateral by placing new real estate mortgages into the cover pool, neither of the two Swiss Pfandbrief institutions has ever suffered a loss. It is also worth highlighting that the opening of bankruptcy proceedings cannot delay payments (both interest and principal) on Pfandbrief loans.

Figure 1
Collateralization provisions in the Swiss Pfandbrief model



Source: Credit Suisse

In the highly unlikely scenario that a Pfandbrief institution was to become insolvent, its liquid assets (primarily invested in high quality securities eligible as collateral with the Swiss National Bank) would be the first to be liquidated. As long as the cover pool is not substantially defective, the Swiss Pfandbriefe would continue to perform normally.

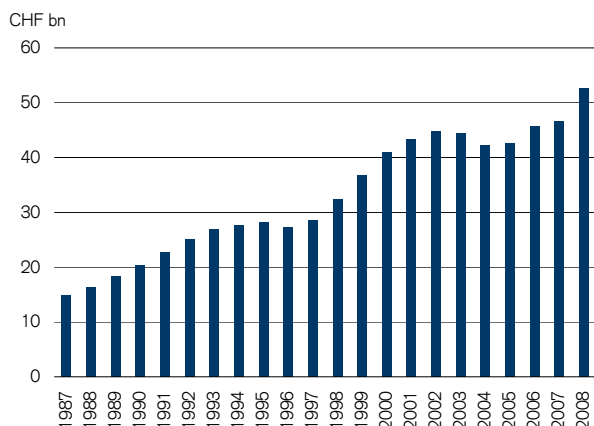
Moody's rates the Swiss Pfandbriefe issued by both the Pfandbriefbank and Pfandbriefzentrale "Aaa, Stable". The rating agency points to the strong legal framework under which these two institutions operate as well as the specific characteristics of the Swiss Pfandbriefe (i.e., high quality of collateral underpinning loans to member banks, over-collateralization, large and diversified pool of borrowers, legislation permitting the segregation of asset pools in situations of stress at member banks, thereby preventing the disruption of cash flows from the pools), which result in a negligible expected loss for investors.

Market structure and developments

Swiss Pfandbriefe, accounting for around 21% of all listed Swiss domestic bonds as per April 2009 (up 3% from the end of 2007), are the second-largest segment on the Swiss domestic bond market after government bonds. Of the 97 Swiss Pfandbriefe with a total nominal value of CHF 47.5 billion listed on the SIX at end-April 2009, CHF 25.5 billion were issued by the Pfandbriefbank (52 issues) and CHF 22.0 billion (45 issues) by the Pfandbriefzentrale. Swiss Pfandbriefe tend to be smaller than those in other European markets, and so-called Jumbo Pfandbriefe (par value of at least CHF 1 billion) play only a minor role. This can be partly explained by the multi-tranche approach by the Pfandbrief institutions to achieve better distribution across maturities which range up to 20 years. The issue size and duration is largely dependent on the refinancing demand from Swiss banks or requests by investors. Aside from listed Swiss Pfandbriefe, the two Pfandbrief institutions have also sizeable private placements outstanding.

As illustrated in Figure 2, the volume of Swiss Pfandbriefe outstanding has expanded sharply over the past two decades

Figure 2
Total Swiss Pfandbriefe outstanding

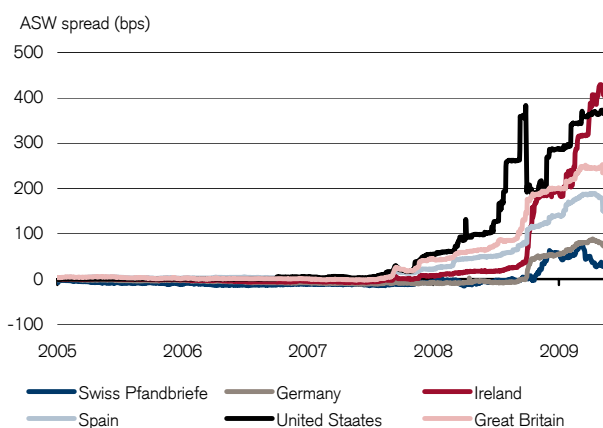


Source: SNB Monthly Report April 2009, Credit Suisse

with an annual growth rate of around 5.9%, which led to improved liquidity in the secondary market. The launch of the Swiss Pfandbrief Index in 2002 increased transparency further. This index is calculated on a daily basis by the SIX Swiss Exchange and shows the price and performance development of the underlying synthetic bonds. In contrast to other European covered bond markets where trading has almost come to a standstill since H2 2007 in view of the financial market turbulence, Swiss Pfandbriefe have remained liquid. Despite the overall increase in ASW spread levels since October 2008 following the worsening of the financial market turmoil, the spread levels of Swiss Pfandbriefe have remained on low levels compared to other covered bond markets or high quality issuers, illustrating the quality of the Swiss Pfandbriefe (Figure 3). Spreads have more recently narrowed back to normal levels since the implementation of the quantitative easing measures by the Swiss National Bank, which included the purchase of Swiss Pfandbriefe.

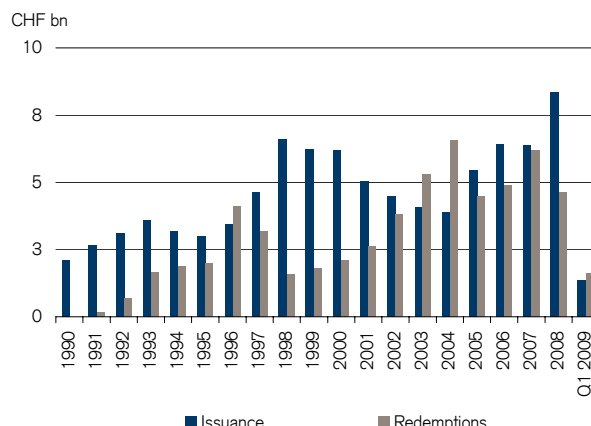
Issuance activity was very lively during 2008 with net new issuance of CHF 3.7 billion versus CHF 0.2 billion in 2007 (Figure 4). The rediscovery by Swiss banks of the Swiss Pfandbrief as a low cost and efficient means to refinance

Figure 3
Covered bonds ASW spreads by countries of origin



Source: Credit Suisse

Figure 4
Swiss Pfandbriefe issuance activity



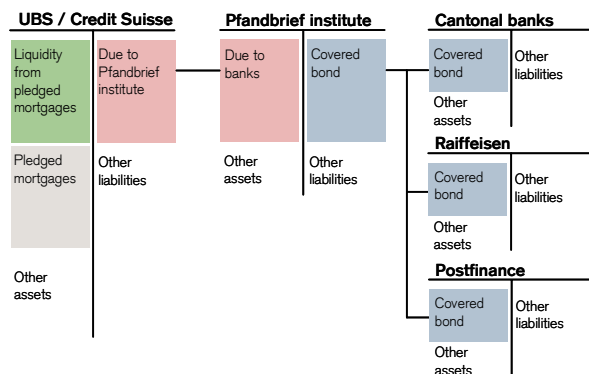
Source: SNB Monthly Report April 2009, Credit Suisse

mortgage lending activities (“supply kick”) on the one hand, and investors’ flight to high-quality liquid bonds combined with a lack of alternatives given the low capital market activity by the public sector in 2008, on the other, explains this development. At end-April 2009, issuance volume already reached CHF 2.9 billion (of which Pfandbriefbank schweizerischer Hypothekarinstitute: CHF 2.0 billion and Pfandbriefzentrale der schweizerischen Kantonalbanken: CHF 0.9 billion), accounting for about 28.2% of domestic CHF issuance (excluding Swiss government bonds).

Active role in stabilizing the Swiss banking system in 2008

After the collapse of Lehman in September 2008, interbank lending virtually stopped in Switzerland much as elsewhere in the world. The two large Swiss banks which are globally active and highly dependent on liquid interbank lending activities were affected. UBS in particular faced strong demand for liquidity as it additionally suffered from large net money outflows. Swiss cantonal banks, Raiffeisen and Postfinance, in contrast, benefited from large new net money inflows but did not have attractive investment opportunities and parked their excess liquidity for virtually zero interest rate at the Swiss National Bank (SNB). Although those banks in need of liquidity would have been able to provide first class securities through their domestic mortgage portfolio to pledge against liquidity, local laws do not allow domestic banks to directly use their mortgage portfolio for borrowing activities. A solution was found making use of the framework provided by Swiss Pfandbriefe. Under the coordination of the SNB, the Pfandbriefbank issued around CHF 2.0 billion in Pfandbriefe privately placed with Zürcher Kantonalbank (ZKB), Postfinance and Raiffeisen, which all had excess liquidity. Borrowing institutions, primarily UBS, in return pledged a large amount of their mortgage portfolio to get access to liquidity via a loan by the Swiss Pfandbriefbank (see Figure 5). In that way, the borrowers were able to access liquidity at a better refinancing rate than what they would have been able to achieve on the market under prevailing credit conditions while the lenders invested their excess liquidity at a

Figure 5
Swiss Pfandbrief transactions



Source: SNB, Credit Suisse

higher yield and at a low risk. The result was beneficial to all parties as well as to the Swiss banking system in general. In March 2009, another CHF 4.75 billion benchmark transaction took place with the two big banks acting as borrowers and the aforementioned institutions being lenders.

Conclusion and outlook

Swiss Pfandbriefe exhibit legal, regulatory and fundamental characteristics, which imply high credit quality and strong safety for investors. Additionally, the Swiss Pfandbrief model has shown its ability to play a crucial intermediary role in allocating liquidity across the banking system at a time when increased counterparty risk brought interbank money markets practically to a standstill. It needs, however, to be noted, that the capitalization of the Swiss Pfandbrief institutions has been stretched on the back of the recent transactions and this bears risks if pursued in an uncontrolled way. The following measures have been taken to prevent this and to maintain the high quality of Pfandbriefe as an asset class. An amendment of the Pfandbriefverordnung has been agreed to allow subordinated debt as capital if Pfandbrief transactions are temporary. Additionally, large private placements must be subject to an approval from the FINMA. In the event that large transactions impact the Pfandbrief institutions' liquidity at maturity, lending institutes have further agreed to allow the Pfandbrief institutions to expand their re-payment schedule in a worst case scenario. Swiss Pfandbriefe can hence be expected to continue playing their safe-haven role in the future and show tight asset swap spreads as a result.

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AA:	Obligor's capacity to meet its financial commitments is very strong
A:	Obligor's capacity to meet its financial commitments is strong
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