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Switzerland: Pfandbriefe
Swiss Institutional Credit Research
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Institutional Research Flash

Credit Update Switzerland

Pfandbriefbank schweizerischer Hypothekarinstitute AG: Sustained growth in FY 2011

Highlights

- Pfandbriefbank posted another year of balance sheet growth combined with stable income streams.
- Additional information provided on the coverage pool revealed more clarity and strengthened our confidence in the high quality and sustainability of the pledged properties.
- Swiss Pfandbrief institutes are important high-quality issuers, with an increasing market share (second largest share of the Swiss domestic market).
- We reiterate our view that investing in Swiss Pfandbriefe is an alternative to Swiss government bonds.

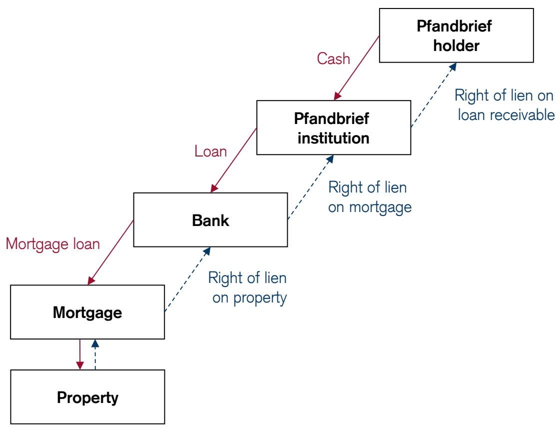
Quadruple security

Swiss Pfandbriefe benefit from a long-term successful track record with no losses since its inception back in 1931, a strict regulation, as well as a stringent regulatory supervision.

The mortgages in the coverage pool must be listed in a cover register ("Pfandregister"), but are still held and managed by the banks themselves (but monitored and independently valued by the Pfandbrief institutions). This is in contrast to mortgage-backed securities, where, mortgages are removed from a bank's balance sheet.

As we already highlighted in various research reports in the past, 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, but also by the mortgage, the member banks with all their assets, and the Pfandbrief institution itself. Should a member bank 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 coverage pool once the claims of the Swiss Pfandbrief creditors were satisfied in full. Further, banks are required to redress insufficient collateral by placing new real estate mortgages into the coverage pool. It is also worth highlighting that the opening of bankruptcy proceedings cannot delay payments (both interest and principal) on Pfandbrief loans. In a worst case scenario with a drop in real estate prices over 50% combined with the bankruptcy of systemically important banks, Pfandbrief institutions would be forced to sell or pledge the coverage pool. The Limmat transaction back in 2009 even carries additional agreements to the already tight regulatory framework to somewhat outbalance a potential risk concentration of the two large banks after this transaction.

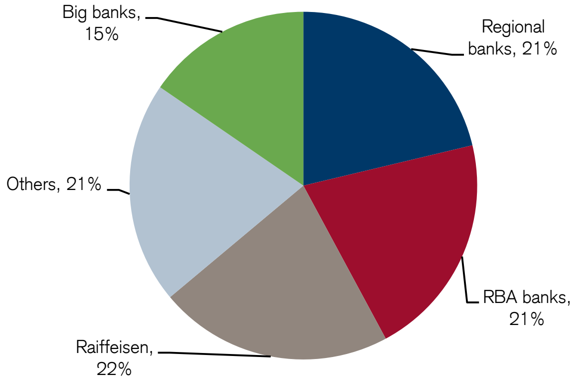
Figure 1
Quadruple security in the Swiss Pfandbrief model



Source: Credit Suisse

Figure 2

Ownership structure of Pfandbriefbank



Source: Company data, Credit Suisse

Another solid set of FY 2011 results

Pfandbriefbank schweizerischer Hypothekarinstitute AG (Pfandbriefbank) recently published its FY 2011 results, which reflected another year of good growth and good sustainability in our view.

Net interest income dropped by 4.5% YoY to CHF 54 m due to the low interest rate environment, despite the growth of the balance sheet overall. While net fee & commission income plays a minor role, net trading income is inexistent as Pfandbriefbank invests is excess cash under buy and hold approach only. The share of almost 100% net interest income of total revenues underpins the main responsibility of the Pfandbriefbank is to offer member banks long-term Pfandbrief loans at rates that are stable and as low as possible (Swiss Pfandbrief law (PfG) Art. 1). Given the lean fix cost base consisting of stable personnel and general costs, the company presented a stable and sustainable net income trend (CHF 47 m last year reflecting a moderate decrease in line with the declining net interest income).

Solid and sustainable balance sheet with strong coverage pool

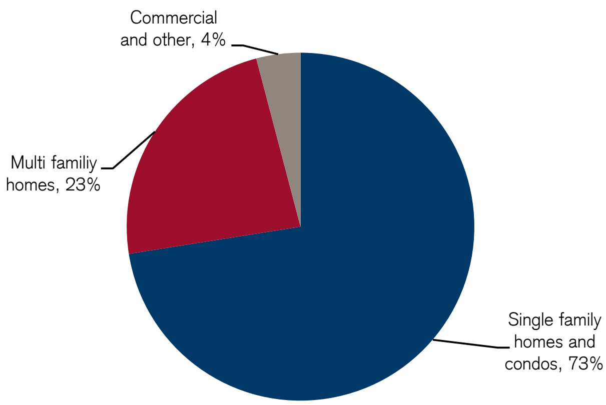
While Pfandbriefbank provides detailed quarterly reports on its coverage pool to Moody's, we appreciate this year's additional information provided in the 2011 annual report. The further details on the coverage pool provide some more clarity and support our general confidence in the sustainability and the high quality of the coverage pool. We expect the company to provide further information – in particular on its coverage pool – over the coming months. Swiss Pfandbriefe are governed by the Swiss Pfandbrief law, which has not been substantially amended since its implementation in 1930, and which further underpins the sustainability of Swiss Pfandbrief in our view. Furthermore, the two Swiss Pfandbrief institutes (Pfandbriefbank schweizerischer Hypothekarinstitute AG and Pfandbriefzentrale der schweizerischen Kantonalbanken AG) and their member banks are under the supervision of FINMA, which provides additional confidence to investors.

In line with the Swiss mortgage market in general, Pfandbriefbank grew its balance sheet again last year as reflected in a 5.6% YoY increase in loans to its member banks. While the increase in general loans grew by 17.0% YoY to CHF 44.3 bn, the loans resulting from the Limmat transaction in 2008 have been further reduced by 46.3% YoY to CHF 4.4 bn. While the Limmat Pfandbriefe, which were created to finance special refinancing needs of the big banks, will be repaid and not replaced, newly issued Pfandbriefe will be issued to refinance the general refinancing needs for all member banks. As such, we expect the overall share of roughly 30% from UBS and Credit Suisse, which includes the "soft-bullet" Limmat Pfandbriefe (21% excluding Limmat), to shrink. At end-2011, we estimate that the two large banks accounted for roughly 30% of the loan pool, followed by Raiffeisen with 20% (representing the largest single lender) and Valiant with 8%, based on the information provided in the various annual reports.

With regard to the coverage pool, Pfandbriefbank highlighted that the total pool consisted of 114,000 prime mortgages coming from 263 various member banks. This

Figure 3

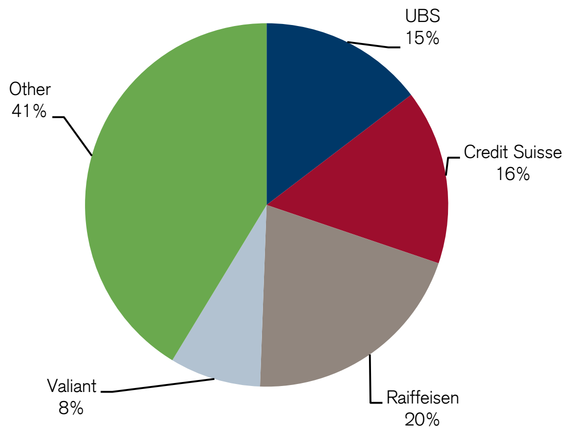
Coverage pool by property type



Source: Company data, Credit Suisse

Figure 4

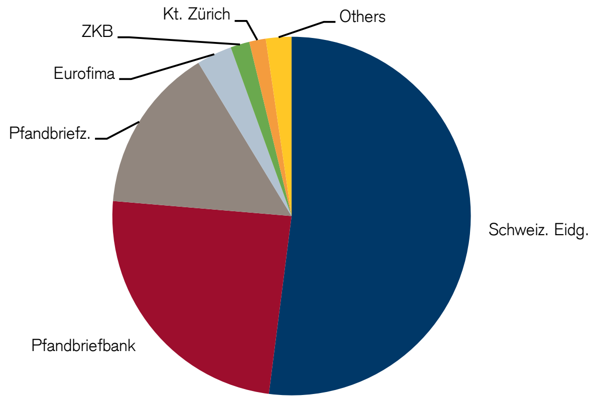
Largest lenders at end-2011 (incl. Limmat-Pfandbriefe)



Source: Company data, UBS, Raiffeisen, Valiant, Credit Suisse

Figure 5

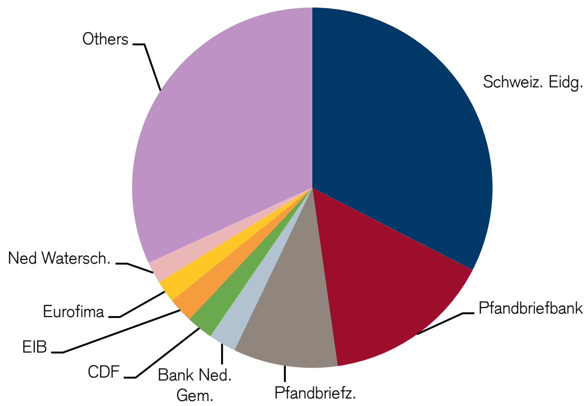
AAA rated CHF domestic bonds (CHF 168.0 bn)



Source: SIX, Bloomberg, Credit Suisse

Figure 7

AAA rated CHF bonds (CHF 268.6 bn)



Source: SIX, Bloomberg, Credit Suisse

calculates an average mortgage of CHF 0.5 m, which is a rather low figure indicating a solid diversification overall. Although the Pfandbrief law limits the maximum loan-to-value (LTV) ratio to 2/3 of the market value, Pfandbriefbank highlighted that the overall marginal LTV ratio of the entire coverage pool is below 50%, according to the company. The maximum amount of a mortgage must not exceed CHF 3.5 m for a single family home and CHF 2.0 m for a condominium, even if the market value of any particular property would allow a higher financing figure. The pool consisted of 73% single family homes and condominiums, 23% apartment buildings and only 4% commercial used properties and others. We expect a very low share of holiday homes given the high quality and strict lending standards of Pfandbriefbank. Across Switzerland, only 9% of the total outstanding mortgages are pledged, which further indicates that the Swiss Pfandbrief institutes are not the sole capital providers of the industry at all. We also point out that Swiss banks only pledge mortgages instead of selling them like other mortgage institutes outside Switzerland. The valuation of the properties is undertaken by the Pfandbriefbank, independently from the value calculated from the member bank, and this value represents the final decision for the coverage pool.

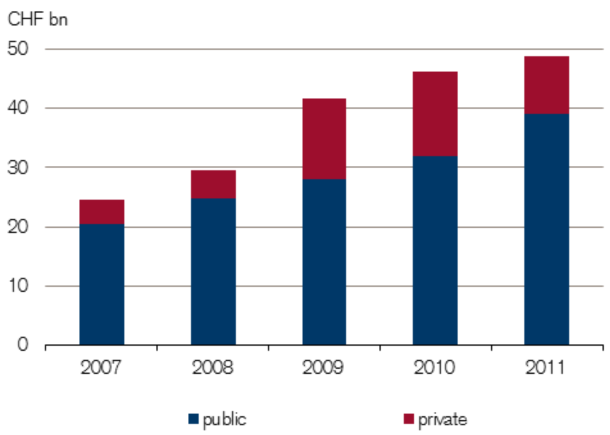
With regard to leverage, the further expansion of the balance sheet resulted in a lower equity coverage ratio of only 104.6% compared to 114.7% the previous year. Given the decreasing capitalization measures due to the growth in line with the market Pfandbriefbank will address this through a capital increase this year.

Swiss Pfandbrief institutes remain a key issuer on the Swiss bond market

Swiss Pfandbrief institutes continue to play a key role in the Swiss domestic bond market, where the overall market share has grown in recent year due to the high issuance activity resulting from a combination of high investor demand for prime quality bonds as well as the growth of the Swiss mortgage market in recent years, which resulted in refinancing needs for the member banks of the two institutes. In April 2012, the CHF domestic bond market had CHF 270.9 bn of outstanding bonds when measured in terms of nominal value. Eidgenossen, with a 32.3% market share, still represented the strongest market constituent followed by Swiss Pfandbriefe

Figure 6

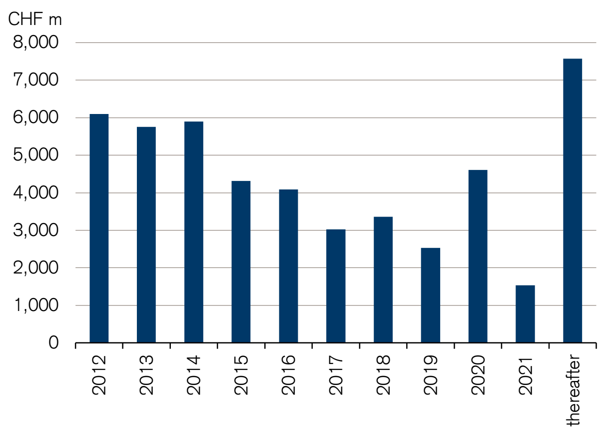
Outstanding Pfandbrief loans



Source: Company data, Credit Suisse

Figure 8

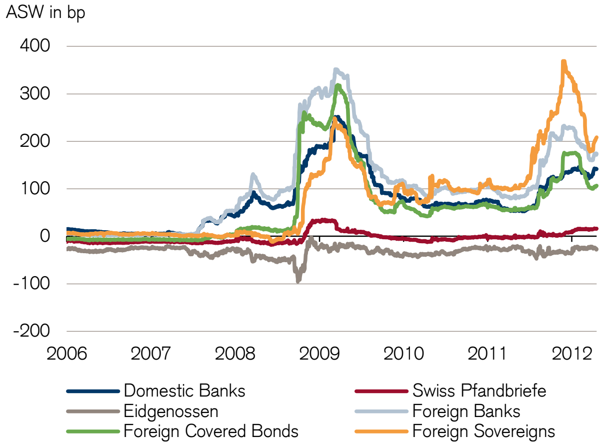
Maturity profile of outstanding Pfandbrief loans



Source: Company data, Credit Suisse

Figure 9

Historical spread developments



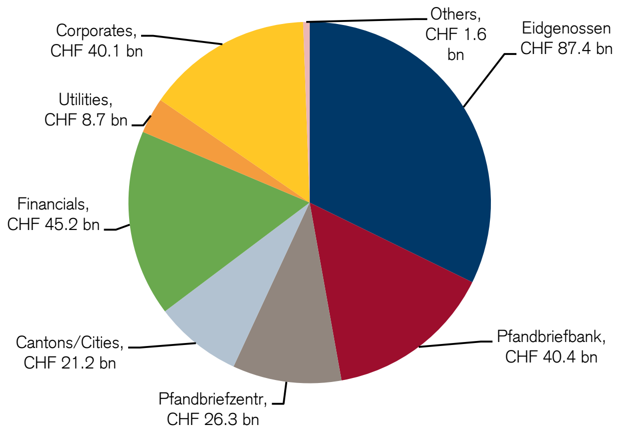
Source: LSI, Credit Suisse

with 24.6% of the market (Pfandbriefbank 14.9%, Pfandbriefzentrale 9.7%). Taking a closer look at AAA rated CHF bonds, we highlight that Swiss Pfandbriefe account for 39% of all CHF domestic bonds and for 25% of all outstanding CHF bonds even when including the foreign segment. With regard to Pfandbriefbank, the maturities are well spread over upcoming years, with no single year being exposed to any substantial refinancing needs. Given the upcoming maturities, the continued good demand from investors and the refinancing needs for member banks, we strongly believe that Pfandbriefbank will remain a regular issuer in the coming months.

Taking a closer look at valuation, Swiss Pfandbriefe proved their resilience to the financial crisis and recessions, as seen with the stable valuation trend through 2008 and thereafter. We see Swiss Pfandbriefe as an interesting alternative to very tight Eidgenossen. For years now, Pfandbriefbank has been rated Aaa by Moody's with a Stable outlook. Its long-term track record, with no losses since its inception in 1930 further supports sustainability in our view.

Figure 10

CHF domestic bond market as of April 2012 (CHF 270.9 bn)



Source: SIX, Bloomberg, Credit Suisse

Conclusion

Pfandbriefbank has continued to grow in line with the Swiss mortgage market and the need for member banks to refinance their mortgage lending business and good demand from investors for high quality bonds. Although Pfandbriefbank provides less detailed information on its mortgage coverage pool than international publicly traded covered bonds, we appreciate the efforts of the company to improve this in the coming weeks as indicated by the management. We are convinced that its long-term track record together with sustainable and stringent statutory regulations and FINMA supervision underpins the high quality of this issuer. Given the high quality of the coverage pool reflected in a good diversification combined with a low LTV ratio, we do not see any substantial downside at this stage, despite the fact that some investors fear a potential bursting of a real estate bubble in Switzerland. We reiterate our view that investing in Pfandbriefbank remains a valuable alternative to Swiss government and/or AAA rated cantonal bonds.

Table 1: Key financial metrics trend

CHF m	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
P&L						
Net interest income (NII)	27	32	33	53	57	54
Net fee & commission income	-2	-1	-1	-2	-1	-1
Net trading income	0	0	0	0	0	0
Operating expenses	6	2	3	10	4	6
Operating profit	19	29	29	41	51	47
Loan loss provisions (LLP)	0	0	0	0	0	0
Net income	19	29	29	41	51	47
Balance sheet						
Total assets	24,194	25,738	30,753	43,527	47,904	50,465
Gross loans to Pfandbriefbank members	23,096	24,619	29,614	41,820	46,197	48,781
Impaired loans	0	0	0	0	0	0
Loan loss reserves	0	0	0	0	0	0
Pfandbrief loans	23,096	24,619	29,614	41,820	46,197	48,781
thereof Pfandbrief loans 'Limmat'	0	0	1,875	10,165	8,240	4,428
Shareholders' equity	688	711	714	949	989	1,025
Market capitalization	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios						
Profitability %						
Net interest margin	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Cost/income ratio	24.0%	7.9%	9.3%	19.9%	7.8%	10.5%
Return on average equity (ROAE)	2.8%	4.1%	4.1%	5.0%	5.3%	4.7%
Return on average assets (ROAA)	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Net interest income/operating revenues	107.0%	102.6%	102.5%	103.5%	102.5%	102.4%
Capital adequacy %						
Equity/loans to Pfandbrief members	3.0%	2.9%	2.4%	2.3%	2.1%	2.1%
Equity/total assets	2.8%	2.8%	2.3%	2.2%	2.1%	2.0%
Asset quality & liquidity %						
LLP/NII	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Non-performing loan ratio	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Company data, Credit Suisse

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