Global

Credit/Covered Bonds

Covered Bond and Agency Update

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Swiss Pfandbriefe - backed by a strong legal framework and solid collateral

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With a volume of over CHF 113bn (including private placements), the Swiss Pfandbrief market is significantly larger than the Swiss government bond market (CHF 77bn). However, with 12% of Swiss mortgages being pledged to Pfandbrief issuers, dependency on Pfandbrief funding is limited. In 2016, Pfandbriefbank schweizerischer Hypothekarinstitute (PSHYPO) issued CHF 9.018bn of Swiss Pfandbriefe, a net growth of CHF 4.052bn. The total outstanding volume of PSHYPO Pfandbriefe amounted to CHF 65.127bn as of year-end 2016. The total balance sheet of PSHYPO amounted to CHF 67.167bn, with equity amounting to CHF 1.596bn.

In our view, Swiss Pfandbriefe are based on a unique and very strong legal framework based pooling model. Only two Swiss institutions are authorised to issue Pfandbriefe, PSHYPO and Pfandbriefzentrale der schweizerischen Kantonalbanken (PBZENT). While the shareholders of PFZENT are cantonal banks, the shareholders of PSHYPO are all kind of non-cantonal banks. As of year-end 2015, the shareholders of PSHYPO were 270 Raiffeisen banks, 60 regional and savings banks, 12 other banks and 2 large private bank. All member banks of PSHYPO can be found on its website (ww.pfandbriefbank.ch/index.cfm?nav=03_Mitgliedbanken). Overall, the shareholders of PSHYPO are extremely well diversified. Pfandbriefe by both issuers are rated Aaa by Moody's and are eligible as collateral for SNB repo transactions. PSHYPO Pfandbriefe are hard-bullet fix rate bonds with a minimum maturity of 3 years but no maximum maturity.

Both Pfandbrief issuers are strictly supervised by the Swiss regulator FINMA. Art. 5 of the Swiss Pfandbrief Act (PfG) limits the scope of business to the following activities: 1) issuance of Swiss Pfandbriefe and extending loans to member banks against eligible collateral; 2) the investment of own funds in asset classes deemed to be safe. The political dimension of Swiss Pfandbriefe can be seen by the members of the board of directors being nominated by the Swiss Federal Council (Bundesrat).

The PfG was established in 1930. It is complemented by the Pfandbrief Ordinance, the statues of the issuers and the valuation regulations. These have to be authorized by the Swiss Bundesrat, again showing the significant political dimension. According to Article 1 of the PfG, the purpose of the Pfandbrief institutes is to enable mortgages for real estate owners at interest rates which are as constant and favorable as possible.

Swiss Pfandbriefe are issued as direct unconditional obligations of the institutions, collateralized by secured loans to the member banks. The issuers pass the proceeds from issuing Pfandbriefe on to the member banks and receive a lien on cover assets. The cover assets remain on the balance sheet of the member banks. Pfandbriefe have to match the tenor and repayment profile of the loans to member banks. Hence, there is no interest rate and duration risk. Given that Pfandbriefe, loans to member banks and mortgage loans have to be denominated in CHF, there is no currency risk.

The PfG stipulates that principal and interest payments of Swiss Pfandbriefe are covered at all times by an equivalent amount of loans to the respective member banks. In our view, the ultimate cover pools backing Swiss Pfandbriefe are of extremely strong credit quality. Extended loans are pledged by first class mortgage denominated in CHF, exclusively located in Switzerland. By law, the maximum LTV is 66.6%. According to Article 32 PfG, if macro economic conditions change materially, FINMA may request a new valuation of real estate properties. In case of PSHYPO, the cover pool is supervised on a daily basis, with the cover pool committee reviewing substantial mortgages, visiting major properties and having close and constant contacts to the member banks.

As the mortgage loans stay on the balance sheet of the member banks and the member banks keep the mortgage certificate, there is no interest of conflict between mortgage loans extension and funding. Moreover, the Pfandbrief issuers are a kind of trustee and/or cover pool monitor. PSHYPO highlights that it values the cover value of a mortgage independently and that member banks are legally obliged to increase coverage in case of insufficient OC. Moreover, impaired loans need to be replaced. According to PSHYPO, it never had a loss since 1931.

In case of PSHYPO, the cover value of the cover pool of each member bank must be at least 108% of the liability of the bank to the Pfandbriefbank. More than 99% of the underlying properties of the cover pool are residential. The average LTV is 43%. Overall, besides the significant political dimension of the product Swiss Pfandbriefe, indicating strong additional support in case of need, there is a fourfold fundamental security: 1. total assets of the Pfandbrief institute; 2. assets of the member banks, 3. assets of the property owners (who are personally liable for the mortgage loans); 4. the value of the property.

In case of insolvency of a member bank, the Pfandbrief institute has a priority claim on the registered collateral. In line with highest covered bond market standards, the insolvency of a member bank does not directly trigger the acceleration of Pfandbriefe. Should there a concern that a member bank is over-indebted, has serious liquidity problems or that the bank no longer fulfills the capital adequacy provisions, FINMA has several intervention options. However, Pfandbrief investors have a special standing. For example, while FINMA can take "protective measures" pursuant to Article 26 of the Banking Act, FINMA cannot not order deferment of payments or payment extension of mortgage- secured receivables of the Pfandbrief institutes.

Appendix 1

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