By **Lukas Wyss** and **Johannes A. Bürgi**, WalderWyss & Partners

The mortgage bond system in Switzerland: an alternative source of finance

The ongoing disruption of credit and capital markets has led banks to invent and pursue refinancing solutions that have previously been used only rarely or that have been used in a different context. Credit portfolios are now sold and transferred to selected investors at substantial discounts rather than to the broader capital markets. Governments around the world have intervened to support financial institutions. Securities satisfying certain collateral eligibility criteria set up by central banks have been created in the framework of securitisation transactions, thus allowing banks to get access to various liquidity programmes introduced by central banks. In recent deals, UBS AG and Credit Suisse issued Swiss Pfandbriefe (i.e. covered mortgage bond) through the Swiss mortgage bond bank (Pfandbriefbank) in private placements aimed at Swiss local retail banks. It is new that such transactions are of such a volume and privately subscribed for by a selected number of financial institutions only and under which the proceeds of such issues have been used for lending purposes to one specific member bank only.

I. BACKGROUND

Since late Spring 2007, the disruption in the credit market has forced banks to create new structures for refinancing credit portfolios and gaining access to liquidity. Whereas the securitisation of credit portfolios and sale of such portfolios to the capital markets used to be a standard process of refinancing, in the current climate these sources of refinancing simply do not exist and are recovering very slowly. Also, the interbank lending market has ground almost to a complete halt since the collapse of Lehman Brothers in September 2008.

Thus, banks are trying to use alternative structures. First and most importantly, central banks have stepped into the gap and are offering liquidity facilities against collateral that would otherwise be illiquid. Also, transactions have been seen under which loan portfolios have been sold to selected investors at substantial discounts rather than to the broader capital market. Hypo Real Estate Group was rescued in a spectacular operation involving assets in various jurisdictions, led by a consortium of the largest German financial institutions and ultimately backed by the Central Bank and the government. Rather than selling troubled assets to investors, some governments and central banks have set up programmes under which such assets have been bought and transferred into off-balance sheet structures, thus providing banks with liquidity and isolating the troubled assets from the balance sheet (bad bank concept).

II. PAST TRANSACTIONS

Sale of loan portfolios to a single or limited number of investors

Rather than selling loan portfolios to the broad capital market, financial institutions started to seek selling opportunities with selected investors. Pressure on the liquidity markets resulted in prices for loan portfolios decreasing dramatically, thus presenting investors with attractive investment opportunities. Also the borrower may be the investor in its own loan, thus, buying its own tranche (which results economically in an early redemption at a discount). The quality of the underlying asset is far from the only element relevant to the price-building process. However, the longer that the credit markets continue to suffer, the more difficult it becomes to close such transactions. Also, legal and operational limitations may make it somewhat cumbersome and time-consuming to transfer large portfolios of residential mortgage loans since, depending on the legal security structure chosen, a large number of individual mortgage notes may have to be isolated and transferred to perfect the security interest (*Faustpfandprinzip*).

Two major transactions involving Swiss banks might be worthwhile mentioning in this respect:

In Switzerland, a deal was publicly announced in May 2008 whereby UBS AG sold a pool of mortgage loans to Black Rock for an announced total purchase price of US$15bn. UBS acquired the loan portfolio at a cost of US$22bn, thus making a loss of 32%. The pool acquisition was financed by US$3.75 billion of equity, raised by Black Rock with its investors and by a secured credit facility of US$11.25bn, provided by UBS AG. For UBS AG, this sale – even though leveraged by itself – resulted in a significant improvement to its risk profile. First, the sale results in UBS AG hedging itself against a further price fluctuation of the loan portfolio up to 25%. Second, the risk weighting of the secured loan advanced to Black Rock is less severe than the risk weighting of the pool of mortgagee loans.

A second deal was announced in Summer 2008 that involved the sale by Credit Suisse

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of a mortgage loan portfolio to GE Real Estate, involving a small number of large mortgage loans forwarded to high-quality borrowers and secured by real property located in the United Kingdom, Germany, Spain and Switzerland. No details have been disclosed as to how GE Real Estate financed the deal.

Creating ABS that are eligible as collateral for central banks

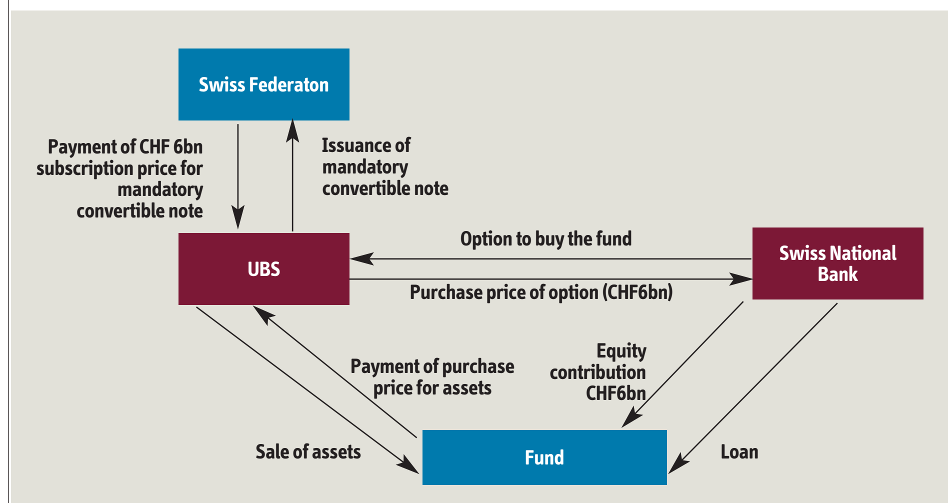
In view of the pressures evident in short-term funding markets, various national banks (such as the Federal Reserve, the European Central Bank and the Swiss National Bank) established liquidity programmes under which secured short-term facilities are provided to banks. The aim was to allow banks to access liquidity for collateral that would otherwise not be liquid in circumstances when the unsecured interbank markets are under stress. Thus, the programmes provide banks with an alternative source of liquidity.

Accordingly, many asset-backed securities (ABS) transactions, some also involving Swiss assets, have been set up and structured in a manner so to create ABS notes that meet the eligibility criteria of the relevant national bank. Such notes are created even in situations where there is no imminent need to trade these notes with national banks, as they simply want to be in a position to have ABS readily available that are more liquid than the underlying assets.

Since the initiation of such liquidity programmes, central banks (in particular the European Central Bank, but also the Swiss National Bank) expanded the amount of liquidity substantially. Such programmes may be expected to be continue unless there is a sudden, unexpected stabilization of the credit markets.

Sale of loan portfolios to structures sponsored by governments or national banks

Another source of liquidity has been made available to banks by setting up government or national bank-sponsored structures to which troubled assets have been transferred. For example, under the Emergency Economic Stabilisation Act 2008, the US House of Representatives and the US Senate created the Troubled Asset Relief Programme, giving the secretary of the treasury the authority to purchase or insure troubled assets or use other means to stabilise the markets. UBS AG and the Swiss National Bank set up a special purpose vehicle (SPV) that was funded with equity of CHF6bn (made available by UBS AG which raised such funds by issuing a mandatory convertible bond to the Swiss Federation) and debt provided by the Swiss National Bank, and bought an entire pool of troubled assets from UBS.



III. UBS AG MORTGAGE BOND TRANSACTION AND MORTGAGE BOND SYSTEM

The deal

In recent deals, both UBS AG and Credit Suisse raised funds with local retail banks that had excess cash readily available. The first deal involving UBS AG was announced in December 2009. UBS AG raised about CHF 2bn from the Zurich Cantonal Bank, the Raiffeisen-Group and Postfinance. The funds have been made available by the three lenders by subscribing to Swiss Pfandbriefe issued by the *Pfandbriefbank Schweizerzischer Hypothekarinstitute* ("Pfandbriefbank") and by the Pfandbriefbank then lending the funds raised to UBS AG against mortgage security. Thus, the transaction was set up within the framework of the Swiss mortgage bond system according to rules set out in the Mortgage Bonds Act in order to facilitate the transaction and strengthen the security package analysis. However, the Swiss mortgage bonds system has never been used to implement a single specific transaction with the aim of allowing a very limited number of subscribers to lend funds to one specific borrower. Rather, the transaction under which institutions lend funds from the Pfandbriefbank or *the Pfandbriefzentrale der schweizerischen Kantonalbanken* ("Pfandbriefzentrale") and transactions under which the investors subscribe for Pfandbriefe are not usually arranged as a single transaction but coordinated in order to ensure the matching of interests and terms. However, this deal demonstrates that the Swiss mortgage bond system might be used as a platform to raise funds in extraordinary circumstances, since the system provides stability and security, and thus may attract other potential lenders.

Swiss mortgage bond system

Overview

The Swiss mortgage bond system was introduced in 1930 and is generally regulated by the Mortgage Bonds Act (1930) and the related Ordinance on Mortgage Bonds of January (1931). The Mortgage Bonds Act overrides the general provisions of the Swiss Code of Obligations and the Federal Act on Debt Collection and Bankruptcy.

Within the framework of the Swiss mortgage bond system, Pfandbriefe are issued to investors. The funds so raised by the Pfandbrief agencies (i.e. either the Pfandbriefbank or the Pfandbriefzentrale) are then lent to the member banks against mortgage security (consisting of mortgage loans). Thus, the system allows member banks to refinance their Swiss mortgage lending business.

The Pfandbrief is a covered bond-like investment instrument and is (indirectly) fully secured by real property located in Switzerland.

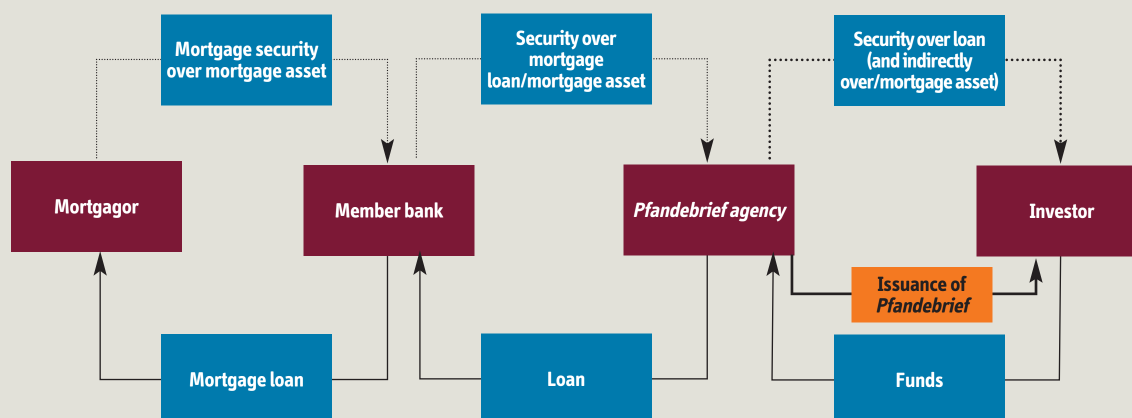
The mortgage bond system essentially involves four parties. The following chart outlines the relationship between the parties.

The parties involved in the Swiss mortgage bond system

Pfandbrief agencies

Pfandbrief agencies issue Pfandbriefe to investors and lend the funds so raised to their member banks on a secured basis. Under the Mortgage Bonds Act, only two institutions are given the authority to issue Pfandbriefe: (i) the Pfandbriefzentrale – set up and held by the Swiss Cantonal Banks and founded in 1931; and (ii) the Pfandbriefbank – set up and held by Swiss non-cantonal banks, also in 1931. The cantonal banks are members and shareholders of the Pfandbriefzentrale, and the non-cantonal banks are members and shareholders of the Swiss mortgage bond bank. Both Pfandbrief agencies are licensed by the Swiss Federal Council and supervised by the Swiss Financial Market Supervisory Authority. The two institutions do not have general banking licences but are, under the Mortgage Bonds Act, authorised only to:

- issue Pfandbriefe;
- lend on the funds raised by the issuance of Pfandbriefe either to their member banks (on a secured basis and on relatively attractive terms) or to non-member banks (on a secured basis but on less favourable terms and under more restrictive eligibility criteria with respect to the collateral pool);
- manage their own assets; and
- conduct any kind of banking business necessary to support the above activities.



Member banks

The member banks may borrow funds from the relevant Pfandbrief agency. Such lending will match a certain issue of Pfandbriefe by the relevant Pfandbrief agency. Loans to member banks must be covered by mortgage loans (and the related mortgage security) granted by the member banks to its clients (mortgagors). Such loans are – subject to certain perfection requirements – secured by law by the relevant pool of mortgage loans. According to section 3 of the Mortgage Bonds Act, Swiss cantonal banks may become members of the Pfandbriefzentrale. Further, any bank licensed to do business in Switzerland may become a member of the Pfandbriefbank, provided that: (i) it is headquartered in Switzerland; and (ii) at least 60% of its balance-sheet assets consist of Swiss mortgage loans. With regard to the second requirement, exemptions may be granted. The Pfandbriefbank waived the second requirement in its articles of association and reduced the threshold to 10%. Thus, any Swiss bank headquartered in Switzerland whose Swiss mortgage loans account for at least 10% of its balance sheet may become a member bank. Foreign banks may not become member banks and, accordingly, will not have access to the Swiss mortgage bond system.

Most of the banks that are licensed to do business in Switzerland and headquartered in Switzerland are members and thus have access to the system. The Pfandbriefbank has roughly 240 member banks.

Mortgagors

The ultimate asset able to be refinanced through the Swiss mortgage bond system is a mortgage loan granted by a member bank to the mortgagor. The legal framework provides strict eligibility criteria for mortgage loans and the underlying mortgage security.

Investors

Investors subscribe for the Pfandbriefe. Each holder of a Pfandbrief is – by law – secured by the loans granted by the Pfandbrief agency to its member banks, and such loans are again secured by the cover pool. The Mortgage Bonds Act not only creates a security interest by law (no security agreement and no security package transfer are necessary), but also provides legal minimum requirements for the cover pool. Accordingly, the investor in a Pfandbrief benefits from a conservative and solid security package. Hence, Pfandbriefe are rated triple-A by Moody's.

Security System

Pfandbriefe are ultimately secured by the mortgage security securing the mortgage loans granted by the member banks to the mortgagors. The Mortgage Bonds Act sets out the security structure, as follows:

- Investors holding Pfandbriefe have a direct security interest in all loans granted by the relevant Pfandbrief agency to its member banks. Neither a security agreement nor any transfer of documents or security would be required in order properly to constitute the security interest, subject to a proper registration of the assets of the cover pool.
- The loans granted by the Pfandbrief agency to a member bank are secured, by operation of law, by a direct security interest over the mortgage loan (and the related mortgage security) granted by the member bank to its mortgagor. Neither a security agreement nor any transfer of documents or security would be necessary in order properly to constitute the security interest subject to a proper registration of the assets of the cover pool.
- The mortgage loans granted by the member banks to the mortgagor must be secured by mortgage security over real property located in Switzerland.

Cover pool

The rules on the cover pool are minimal requirements set up by the Mortgage Bonds Act. Each Pfandbrief agency may set up more restrictive principles (and both Pfandbrief agencies have done so). However, given that the rules on the cover pool provided by the act are strict and conservative, these rules are the essence of the nature of the Pfandbrief.

Coverage

Loans made available by Pfandbrief agencies to their member banks plus interest thereon must be covered by eligible mortgage loans in an amount of not less than 100% of the loans. Where the total interest on the mortgage loans contained in the cover pool is lower than the interest to be paid on the loan, the collateral pool must be increased in order to cover the potential shortfall. Both Pfandbrief agencies increased the coverage ratio with regard to principal and interest. Such requirements may occasionally change.

Real property located in Switzerland

The mortgage loans must be secured by real property and land located in Switzerland (or Pfandbriefe that satisfy all criteria). Public sector assets do not qualify as eligible collateral. Also, real property exposed to a decline in value due to exploitation (e.g. mines) are not eligible.

Loan-to-value ratios of mortgage loans

The most important feature of the reliability of the Swiss mortgage bond system is the loan-to-value ratio (LTV) protection of the investors provided by the act. According to section 34(2), the LTV of mortgage loans may not exceed two-thirds of the fair market value of the property. In the case of agricultural land, this value is the lower of either five-sixths of the profitability value or two-thirds of the fair market value, and in the case of construction sites, this value is less than two-thirds. Pfandbrief agencies may impose stricter LTVs where they see fit (e.g. the Pfandbriefbank requires an LTV of one-half with regard to commercial property and holiday homes).

Holding of mortgage loans and mortgage security by operation of law

Mortgage loans, and accordingly mortgage security, will be held at all times by the relevant member bank. Thus, no transfer of title

is necessary. This may facilitate the process substantially (other than within the framework of a secured financing or refinancing outside the mortgage bond system). This concept avoids any issues with applicable dispossession requirements (Faustpfandprinzip), if applicable, and is an important feature of the system since the mortgage loans as well as the security thereon may easily be serviced by the member bank itself. Outsourcing the servicing might otherwise become problematic with regard to banking secrecy, the outsourcing rules and data protection, unless waivers could be obtained by each mortgagor.

Registration of assets in the cover pool

Both Pfandbrief agencies and the member banks must maintain a collateral register in which each mortgage loan, as well as further details of the mortgage security (in particular of the real property) is registered. The Ordinance on Mortgage Bonds lists in detail all the information that must be registered in such registers. According to the Mortgage Bonds Act, it is a requirement of the constitution of the security interest that cover pool assets be properly registered. No security interest will exist where the cover pool assets are unregistered. Once properly registered, the security interest is constituted and perfection requirements that would be required outside the Swiss mortgage bond system (such as physical transfer of mortgage notes to the pledgee) are not applicable. This is an important element of the system that facilitates daily business of the member bank substantially.

Substitution of assets

Cover pool provided by the member banks may be dynamic. Thus, assets may be taken out of the pool and other assets may be added. Where the cash flow generated under the cover pool (i.e. mainly the interest payments) is lower than the interest to be paid under the loan granted by the Pfandbrief agency, the cover pool must be increased accordingly. In order to cover any shortfall in the cover pool, the relevant member bank may temporarily provide cash or marketable bonds issued by the government, the cantons or the municipalities. Such bonds must be valued at 95% of their quoted market price. Also, according to regulations set up by the Pfandbriefbank, impaired loans or non-performing loans must be substituted.

Valuation of real property

The Mortgage Bond Act provides certain valuation principles with which the Pfandbrief agencies must comply. For example, valuations must be conducted periodically and by steadily applying the same valuation rules. The valuation process by the Pfandbrief agencies and the member banks is monitored and supervised by the Financial Market Supervisory Authority. The authority may require a revaluation where a fundamental change of circumstances has occurred.

No derivatives

The Mortgage Bond Act does not include provisions allowing Pfandbrief agencies to enter into derivatives transactions. However, a currency hedge is not necessary, since the loans and Pfandbriefe must be denominated in Swiss francs. The requirement for a series of Pfandbriefe to match the loans granted to member banks (for example, with regard to term and interests) reduces the need for interest rate hedging considerably.

Pfandbrief agencies and in particular the cover pool will be audited by special auditors and the process is under the supervision of the authority.

Characteristics of Swiss Mortgage Bonds System

Access for Swiss banks only

Only banks headquartered in Switzerland may become members (and accordingly shareholders) of the Pfandbriefbank. With regard to the Pfandbriefzentrale, the circle of members is limited to cantonal banks. Thus, no foreign banks have access to the Swiss mortgage bond system.

According to section 26 of the Mortgage Bond Act, loans may be granted to non-member banks. However, the system is not the same for non-member banks. First, the banks must provide collateral in an amount of 105% of the loans borrowed. Second, the security interest may be created not by registering the assets of the cover pool in the respective registers (other than when lending to member banks), but by pledging the assets according to the general provisions of the Civil Code. As a result, creating a security interest is more burdensome from a practical point of view (in particular with regard to the transfer requirements of the mortgage notes securing the mortgage loan). Thus, it seems that the option to lend funds to non-member banks is simply not feasible. Furthermore, according to internal regulation of the Pfandbriefbank, loans to non-member banks shall be granted only in extraordinary circumstances. For example, it is acceptable to grant loans to nonmember banks that are soon to become member banks.

Conservative legal framework

The legal framework of the mortgage bond system is conservative as to the leverage member banks can achieve. Accordingly, the system is regarded as reliable and stable, even during financial crises. In this respect, the bonds issued by the Pfandbrief agencies are still rated triple-A by Moody's. With regard to Pfandbriefe issued by the Pfandbriefbank, in November 2005 Moody's wrote:

"The triple-A long-term rating assigned to the Pfandbrief issues (covered bonds) of Pfandbriefbank Schweizerischer Hypothekarinstitute (Pfandbriefbank) ... is underpinned by the strong institutional framework within which Pfandbriefbank operates, as well as by the specific characteristics of the Pfandbriefe which result in a negligible expected loss for investors. The triple-A rating is not an issuer rating but is only applicable to the covered bonds issued by Pfandbriefbank."

On-balance sheet financing

Typical for a covered bond and other than in the framework of most of the ABS, residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) issues, the issue of Pfandbriefe (and any other covered bond) is a typical on-balance sheet lending transaction – that is, the relevant assets remain on the balance sheet of member banks and the Pfandbriefzentrale.

No limited recourse

Whereas the limited recourse element is typical to ABS, RMBS and CMBS transactions, the investor in a Pfandbrief is secured not only by the cover pool, but also has full redress to both the relevant Pfandbrief agency (directly) and the member banks (indirectly). Thus, in circumstances where the cover pool would not cover the Pfandbriefe (a very unlikely scenario), the investor in Pfandbriefe could get full redress.

No additional credit enhancement

Typically, there are no additional credit enhancement features in the Swiss mortgage bond system. However, substantial credit enhancement is provided by the structure itself, since most of the risks in the structure are eliminated by legal requirements of the system. Liquidity facilities and similar facilities are usually not necessary, since the cover pool must be set up conservatively and Pfandbrief agencies are also subject to a debt-to-equity ratio requirement.

No segregation of assets in cover pool

Typically in an ABS, CMBS or RMBS issue, specific assets cover a specific issue of an ABS. However, under the Swiss mortgage bond system, all assets of the cover pool cover all issues of a series of Pfandbriefe. Accordingly, investor risk with regard to different series of Pfandbriefe does not vary, since the same cover pool and the same Pfandbrief agency and member banks provide security for such Pfandbriefe.

IV. PARTICULARITIES OF UNILATERAL COVERED BOND ISSUANCE AND POTENTIAL FUTURE TRANSACTIONS

Typically, the granting of a loan by a Pfandbrief agency to a member bank on the one hand and the issuance of Pfandbriefe on the other are not arranged as one transaction. Whereas the cash flows of the Pfandbrief, the loans to member banks and the underlying mortgage loans must match in terms of interest and term, investors subscribing for Pfandbriefe are not doing so with the purpose

of lending funds to one specific member bank.

The standard procedure is that, before the issuance of a new series of Pfandbriefe, the Pfandbrief agency offers its member banks the refinancing of existing loans that are due for repayment or the granting of new loans.

Usually, series of Pfandbriefe are issued with a total volume of between CHF 200 million and CHF300m, and are subscribed by a larger, unrelated group of investors. Thus, it is unusual to have one issue of Pfandbriefe in an amount of CHF2bn or more that is subscribed by only a selected number of investors.

However, the unilateral transaction seen in the last couple of months shows that the Swiss mortgage bond system may become an efficient refinancing tool in situations where a secured refinancing transaction is difficult to structure or an off-balance sheet securitization is not possible due to a lack of market. The benefit of using the mortgage bond system is that – other than within the framework of a secured refinancing transaction – the security interest is created by law when the details of the assets in the cover pool are properly registered, with no physical transfer being necessary. This allows the member bank to continue to service the assets contained in the cover pool. Also, the monitoring of the cover pool is facilitated due to the registration system as well as under the control (and additional supervision) of the Pfandbriefbank. From the lenders' (or investors') perspective, excess liquidity may be invested into an interest-bearing instrument that is liquid and secure even in times of economic crisis. Such investments are hard to find. The system offers attractive terms for refinancing where it would otherwise be costly and complicated.

However, the downside is the stringent LTV requirements for assets included in the cover pool.

V. OUTLOOK

A few numbers of transactions have been closed in the last couple of months, involving Credit Suisse and UBS AG. It may be expected that in the near future other member banks will try to arrange refinancing transactions through the Swiss mortgage bond system. According to public information, additional issues amounting to a total of up to CHF20bn may be expected in 2009.

Were all these transactions to be consummated as announced through the Swiss mortgage bond system, the legal framework relating to the Pfandbrief agencies (in particular the Pfandbriefbank) may require some adjustment. The Pfandbriefbank would need further equity in order to comply with the leverage ratios imposed by the Mortgage Bonds Act. Since such need of equity may be only temporary, equity infusions by subordinated debt provided by the member banks are the most likely option. Also, the Pfandbrief agencies would be exposed to an increased risk related to single loans made available to member banks in the framework of such transactions. One solution to mitigate this risk would be to bring back a (limited) element of limited recourse into the structure. That is, investors would agree not to enforce under the Pfandbrief they are holding unless the relevant member bank repaid the respective loan or the relevant assets of the cover pool were enforced. Otherwise, the Pfandbrief agency would risk running short of liquidity in situations where the Pfandbrief became due and payable and the relevant member bank had not repaid the corresponding loan. In such a scenario, repayment of the Pfandbrief would have to be delayed until the assets of the cover pool had been collected.

For further information on this topic please contact Johannes Bürgi or Lukas Wyss at Walder Wyss & Partners by telephone (+41 44 498 98 98) or by email (lwyss@wwp.ch or jbuergi@wwp.ch).

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Attorneys at Law

A good overview requires distance

What makes ww&p a leading source of legal services in Switzerland?
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But more than that, it is the culture of our firm that has made us a leading source of legal services.

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Walder Wyss & Partners
Attorneys at Law

Seefeldstrasse 123
P.O. Box 1236
CH-8034 Zurich

Phone +41 44 498 98 98
Fax +41 44 498 98 99
reception@wwp.ch

wwp_overview_hp_170_254