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Covered Bonds – A cost-efficient and crisis-resistant financing tool for Swiss banks

1. Introduction

Swiss contractual covered bonds emerged in the wake of the global financial crisis of 2008-2010 and have since established themselves as a cost-effective and crisis-resistant funding instrument for Swiss banks, complementing the traditionally strong funding from customer deposits, other capital market instruments and the Swiss Pfandbrief.

Due to their contractual nature, covered bond programs can be tailored to the specific needs and loan books of the bank that seeks financing. In the case of mortgage loan portfolios used as cover, there is for example typically flexibility with respect to the suitable loan type (residential and commercial) or the maximum loan-to-value (LTV) of the underlying mortgage loans. Similarly, covered bond may be issued in different currencies.

Thanks to this flexibility offered by contractual covered bonds, the number of covered bond transactions in Switzerland involving residential and commercial mortgage loans has increased significantly in recent years, with first-time issuers launching new programs in 2020, 2022 and 2023, the most recent of which was launched by a global Swiss bank with a volume of several billion Swiss francs. Swiss covered bond programs regularly meet the requirements for a AAA rating thanks to the high-quality cover assets used.

While mortgage loan portfolios are typically used as collateral for covered bonds, other types of loan books (such as auto leases, lombard loans or corporate loans) may also be suitable for the implementation of a contractual covered bond. As a result, an increasing number of non-banks are also exploring refinancing via the Swiss covered bond.

2. Typical Structure

2.1. Overview

Typical Swiss contractual covered bond structures include the following elements, among others :

- **Issuer:** A Swiss bank issues covered bonds, which are direct, unconditional and unsubordinated obligations of the issuer. The covered bonds are issued under a program with a corresponding offering and listing prospectus in accordance with the Swiss Financial Services Act (FinSA) and are regularly listed on SIX Swiss Exchange. The covered bonds are governed by Swiss law.
- **Guarantor:** The obligations of the issuer under the covered bonds are guaranteed by a subsidiary of the issuer under a guarantee mandate for the benefit of the holders of the covered bonds, represented by the bondholders' representative/trustee.
- **Bondholders' representative/trustee:** The holders of the covered bonds are represented by the bondholders' representative/trustee, that safeguards the interests of the covered bondholders.
- **Guarantee mandate:** Under the guarantee mandate, all liabilities, costs and expenses incurred by the

guarantor under or in connection with its guarantee will need to be reimbursed (or pre-financed) by the issuer.

- Cover pool: As collateral for the guarantor's reimbursement and pre-financing claims, the issuer transfers a pool of assets (cover pool assets) to the guarantor. If the issuer of the covered bonds defaults and the guarantee is called upon, the guarantor can demand payment of the reimbursement and pre-financing claims from the issuer under the guarantee mandate. If the issuer is unable to pre-finance the payments due under the guarantee mandate, the guarantor can enforce the cover pool and use the proceeds to fulfill its payment obligations under the guarantee. The cover pool only secures the guarantor's claims for reimbursement and pre-financing against the issuer under the guarantee mandate, but not the claims of the covered bond holders under the guarantee, i.e. the guarantee is legally unsecured. The issuer's obligations under the covered bonds are also (apart from the guarantee) unsecured obligations of the issuer.
- Contractual documentation and applicable law: The contractual documentation of covered bond programs is governed by Swiss law (with the exception of any swap documentation required to address interest rate and currency risk, which is typically governed by English law).

2.2. Issuer

In addition to making interest and principal payments under the covered bonds, the main obligation of the issuer under the covered bond programs is to maintain an appropriate level of eligible cover pool assets in the cover pool at all times. Legally, the cover pool assets are transferred to the guarantor for security purposes and thus become property of the guarantor. The issuer typically continues to service the cover pool assets until the occurrence of pre-defined trigger events.

2.3. Guarantor

The guarantor is non-operational special purpose vehicle established for the purposes of the covered bond program in the form of a Swiss stock corporation. The majority of the guarantor's shares are held by the issuer itself, with two minority shareholders independent of the issuer (so-called golden share structure). These minority shareholders are also members of the guarantor's board of directors independent of the issuer. According to the guarantor's articles of association and other constitutional documents, the two independent board members/shareholders have a veto right on all relevant decisions at the shareholder's and board of directors' level. This corporate governance structure and certain additional measures safeguard the independence and functioning of the guarantor also in case of a default of the issuer.

The guarantor is set-up as a bankruptcy-remote special purpose vehicle. As Swiss law does not provide for a special type of corporate entity or framework in this respect, the entity is set up under the legal framework generally available and bankruptcy remoteness is achieved by way of implementing various measures. For example, the corporate purpose of the guarantor is limited and consists primarily of issuing the guarantee, holding the cover pool and, if required, liquidating it. As a consequence, the guarantor is only allowed to enter into agreements and transactions required for the covered bond program. Furthermore, the transaction documentation amongst the parties to the program provides for limited recourse and non-petition provisions further strengthening the guarantor's bankruptcy resistance. The guarantor has no further executive bodies or own employees and appoints various third party service

providers, such as the account bank, the cash manager, the corporate servicers, the administrator, etc. that are all bound by the transaction documentation.

2.4. Bondholders' representative

The bondholders' representative/trustee is appointed by the covered bondholders as their representative with respect to the guarantee issued in favour of the covered bondholders. In this role, the bondholders' representative/trustee safeguards the interest of the covered bondholders, such as in case of applicable events of default.

2.5. Guarantee

The guarantee is provided by the guarantor for the benefit of the covered bondholders, represented for these purposes by the bondholders' representative/trustee. The guarantee is issued for the account and risk of the issuer, that pays a guarantee fee to the guarantor. In case the guarantee gets activated, the issuer will need to indemnify and pre-fund the guarantor for all amounts payable under or in connection with the guarantee.

2.6. Cover pool

In case of cover pools consisting of mortgage loans, such loans are transferred to the guarantor together with the associated mortgage certificates for security purposes. The loans are typically residential mortgage loans, although depending on the program, also commercial mortgage loans may be permitted to a certain fraction of the overall cover pool. The mortgage loans (and the related mortgage notes) are not sold to the guarantor, but are transferred for security purposes and the assets thus stay on the balance sheet of the issuer. The guarantor acquires full legal title in the mortgage claims and the entitlement to the mortgage notes, which again represent a lien on the encumbered properties. Such mortgage loan assets may be complemented by certain substitute assets (in particular cash or liquid debt instruments).

An initial cover pool is transferred to the guarantor at the inception of each issuance of covered bonds. The composition of the cover pool must continuously fulfill certain criteria, including a maximum LTV and a minimum amount of over-collateralization that is accepted by the rating agencies. Accordingly, the cover pool assets in the cover pool must be regularly replenished and replaced to ensure ongoing compliance with the relevant eligibility criteria. Also, certain tests (such as an interest coverage tests and an asset coverage tests) are regularly conducted and corresponding reports are published for the benefit of the covered bondholders.

The covered bondholders have direct recourse against the issuer for their claims under the covered bonds. In addition, they benefit from the guarantor's guarantee, which is backed by cover pool assets (so-called dual recourse). In the event of the issuer's insolvency, the guarantor as owner of the cover pool may administer and enforce the cover pool independently of any insolvency proceedings against the issuer, subject to any avoidance actions. In particular, upon the occurrence of an enforcement event, the guarantor is entitled to realize a sufficient portion of the cover pool by collecting the mortgage loans or, subject to certain restrictions, by private sale to a suitable purchaser.

In order to safeguard the interests of the mortgage debtors, certain measures are implemented, including

that the transferred mortgage certificates continue to secure only the associated mortgage loans and can only be enforced when the conditions contractually agreed with the mortgage debtor for the enforcement of the mortgage note have been met.

2.7. Servicing

The servicing of the transferred cover pool assets will regularly continue to be carried out by the issuer. Other roles in the structures are also often carried out by the issuer, such as the role of the account bank (i.e. the bank managing the guarantor's account) or the cash manager. The covered bond structures then regularly provide for predefined trigger events for the various service provider roles (such as those of the servicer, the account bank and the cash manager), the occurrence of which requires the replacement of the respective provider. Such triggers typically include thresholds for certain minimum ratings that the service providers need to meet.

3. Certain regulatory and tax aspects

3.1. Overview

Switzerland has not enacted any specific primary legislation covering covered bond transactions. Instead, covered bond transactions in Switzerland have been developed and are structured under the general legal and regulatory framework available, such as the Swiss Code of Obligations (e.g., relating to the formation of the guarantor and the transfer of cover pool assets), the Swiss Civil Code (e.g., relating to security interests), general capital market regulations and regulatory and tax laws.

3.2. Licensing requirements

In the absence of specific covered bond legislation in Switzerland, there are no licensing requirements per se for the guarantor and servicers. However, general regulatory and licensing requirements under applicable financial market regulations, including the Swiss Federal Banking Act and Swiss anti-money laundering regulations, must be observed. Depending on the assets serving as collateral for a covered bond, also other regulations may be relevant, including (but not limited to) the Swiss Consumer Credit Act (e.g. in relation to retail vehicle leasing assets), the Federal Act on the Acquisition of Real Estate by Persons Abroad (so-called Lex Koller) (e.g. in relation to residential mortgage loans) or the Insurance Supervision Act (in relation to licensed insurance companies acting as transaction party). The practice with respect to the regulatory treatment of covered bond transactions is well established, and confirmation from the Swiss Financial Market Supervisory Authority (FINMA) and other competent authorities regarding certain regulatory aspects of a specific covered bond transaction and the transaction parties involved is typically sought prior to the implementation of the transaction.

3.3. Investors

Under Swiss law, there are in principle no restrictions on the type of investors that may invest in covered bonds (publicly or privately placed). However, the financial intermediaries involved in the placement of the covered bonds must comply with their obligations under financial market laws (such as the Financial Services Act (FinSA)), including, where applicable, with respect to assessing the appropriateness and suitability of such products for investors. Further restrictions apply with respect to the targeting of non-

Swiss investors and foreign capital market regulations that must be complied with if the covered bonds are also placed outside Switzerland.

3.4. Prospectus rules

Covered bond issuances by Swiss banks are typically set-up as a program, allowing the issuer a short "time to market" for its issuances. For that purpose, a base prospectus complying with the requirements of the FinSA and the corresponding ordinance (FinSO) is prepared by the issuer, pre-approved by a FINMA licensed prospectus review body and published. The base prospectus is then supplemented by the final terms of a specific issuance of covered bonds.

3.5. Tax aspects

Covered bonds issued by a Swiss bank qualify as instruments of collective fund raising for Swiss federal withholding tax purposes. Accordingly, interest payments on such instruments, be they periodic or by original issue discount or premium, are subject to the 35 per cent Swiss federal withholding tax. Furthermore, when Swiss mortgages serve as collateral, special cantonal and federal withholding taxes may need to be considered. In addition, transfer pricing and Swiss VAT should be looked at carefully. The practice with respect to the tax aspects of covered bond transactions is well established and typically, comfort is sought by affirmative advance tax ruling confirmations from the competent tax authorities with respect to the tax aspects of a specific covered bond transaction.

4. Outlook

Following an analysis of the developments relating to Credit Suisse Group AG, the Swiss Federal Council adopted a report on banking stability in 2024, outlining various measures to improve the supervision and resolvability of Swiss systemically important banks, including the possible introduction of legislation specific to covered bonds in Switzerland.

Although the practice of contractual covered bonds is well established in the Swiss market, a formal legal framework for certain specific aspects of covered bond transactions in Switzerland would generally be viewed positively as further strengthening the instrument, reducing its costs and thus potentially allowing smaller market participants to use these instruments as a reliable source of funding. Such elements may include, but are not limited to, the introduction of a specific bankruptcy remote corporate entity for covered bonds (and securitization transactions) similar to those available in other jurisdictions, the introduction of a lien register (similar to the legislation of the Swiss Pfandbrief), the regulation of certain aspects relating to clawback and payment waterfalls, and certain regulatory and tax aspects. In addition, a formal regulation of certain aspects of covered bonds may further strengthen its role as a crisis-resistant instrument with respect to an eligibility as collateral for repurchase and emergency liquidity transactions with the Swiss National Bank (SNB).

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