

3.29.1 SWITZERLAND - PFANDBRIEFE

By Jörg Schmid, Pfandbriefbank schweizerischer Hypothekarinstitute AG

I. FRAMEWORK

The issuance of Swiss Pfandbriefe – a label protected by law - is governed by the 'Pfandbriefgesetz' (PfG) effective 25 June 1930. Since then the PfG was only marginally modified. It contains only 52 articles and is complemented by the 'Pfandbriefverordnung' (PfV) and the valuation regulations.

The Swiss Pfandbrief is more than a mere covered bond because in case of the Swiss Pfandbrief the coverage is legally determined in comparison to a covered bond with a coverage which is only based on a private agreement between issuer and investor.

As of article 1 of the PfG the Pfandbrief institutes have the purpose to grant real estate owners long term mortgages at constant and cheap interest rates. Generally speaking, the Swiss Pfandbrief is a major means to close the refinancing gap of member banks.

II. STRUCTURE OF THE ISSUER

The PfG grants the right to issue Swiss Pfandbriefe exclusively to two Swiss Pfandbrief institutes, namely the Pfandbriefzentrale der schweizerischen Kantonalbanken AG (PBZ) and the Pfandbriefbank schweizerischer Hypothekarinstitute AG (PBB). The first operates as the Pfandbrief issuing vehicle of the Swiss cantonal banks and the latter of all other Swiss banks. The PfG grants these two institutes the right to merge. Both are special banks with their business scope limited to the issuance of Swiss Pfandbriefe, to granting loans to their member banks and to investing their share capital and reserves. They are owned by their member banks.

The cantonal banks are public-sector banks and majority-owned by the canton (Swiss region) in which they are incorporated. Most cantonal banks benefit from a state guarantee extended by their canton¹.

To issue Swiss Pfandbriefe the authorisation of the government is required. Both Pfandbrief institutes are supervised by the Swiss banking regulator, the Eidgenössische Finanzmarktaufsicht (FINMA).

Even if it looks like it at first glance, it is not a duopoly. The two Pfandbrief institutes are self-help-organizations, or in other words, the bond issuing departments and cover pool of their member banks outsourced to the Pfandbrief institutes. Switzerland is too small a country for every bank to issue Swiss Pfandbriefe. Pooling makes sense and is an additional strength.

PBZ was founded in 1931 and has 24 member banks. Only cantonal banks have the right to be members of the PBZ (PfG Art. 3). PBZ does not have its own staff but has fully outsourced its operations to Zürcher Kantonalbank. As of 31 March 2011 the total outstanding Swiss Pfandbriefe of PBZ amount to CHF 24.0 billion (EUR 18.4 billion).

PBB was founded in 1930 and counts 239 member banks. Any Swiss bank has the right to become a member of PBB, provided that it is headquartered in Switzerland and that Swiss mortgages account for at least 60 % of the bank's balance sheet. The board of directors can accept banks with a lower mortgage/balance sheet ratio. As of 31 December 2010 the total outstanding Swiss Pfandbriefe of PBB amount to

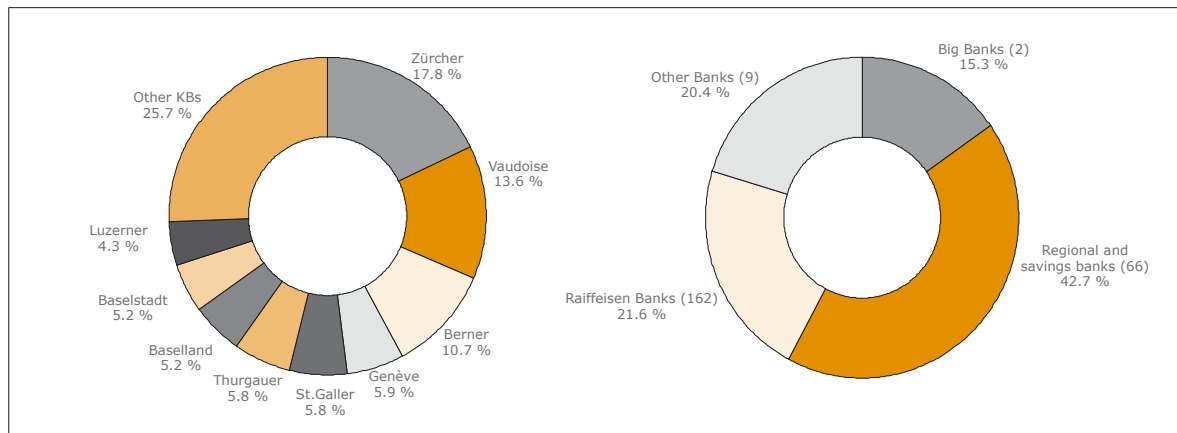
¹ Three of PBZ's member banks do not benefit from a cantonal guarantee or have a limited guarantee, namely Banque Cantonale de Genève AG (limited guarantee), Banque Cantonale Vaudoise AG (no guarantee) and Berner Kantonalbank (limited guarantee until end of 2012).

CHF 46.2 billion (EUR 37.0 billion). PBB operates with 7 employees, a cost income ratio of 5.5 % and a profit of CHF 51.2 million (EUR 41.0 million) for the business year 2010.

The chart below shows the structure of the shareholders:

> CHART 1: SHAREHOLDERS OF PBZ

> CHART 2: SHAREHOLDERS OF PBB



Source: PBZ, as of 31.03.2010

Source: PBB, as of 31.12.2010

From the beginning Moody's has rated Swiss Pfandbriefe with Triple A. The Swiss National Bank accepts Swiss Pfandbriefe as collateral for the repo pool.

Swiss Pfandbriefe are standardised to a great extent. They are a commodity, denominated only in Swiss francs, with a long-term duration of 3 to 22 years and always with a fixed coupon. They are issued at the due date of a matured Pfandbrief, if the conditions for a new issuance are favourable or tailor-made on the basis of an investor demand. The size of an issuance depends either on the demand of the member banks for loans or on the demand of the investors for Swiss Pfandbriefe, whichever is smaller. The average size is about CHF 536 million. Whenever possible, existing bonds are reopened. The maximum size should not exceed CHF 1 billion.

Swiss Pfandbriefe are issued either as public bonds or as private placements. Public bonds are issued through a banking syndicate at fixed conditions, while private placements are issued by the Pfandbrief institutes themselves.

The issuing price or investor's yield depends on the duration of the bond, the interest curve, the coupon and the issuing volume. Further pricing information is obtained from the secondary market of all other outstanding Swiss Pfandbriefe and from the comparison with other bond issuers. For example: on 8 March 2011 PBB issued series 539 with a duration of 9.7 years at Swap Mid minus 8.0 basis points.

All of the about 110 publicly issued Swiss Pfandbriefe are listed on the Swiss Exchange. Swiss Pfandbriefe amount to 22.4 % of all bonds listed on the Stock Exchange. Private placements are not listed.

The total volume of all outstanding Swiss Pfandbriefe as of 31 December 2010 amounts to CHF 69.7 billion (EUR 55.8 billion). For years the two Swiss Pfandbrief institutes have been the major bond issuers in Switzerland, even more important than the government. In 2010 they issued Swiss Pfandbriefe amounting to CHF 13.5 billion (EUR 10.8 billion).

About 20 % of investors in Swiss Pfandbriefe are pension schemes, 25 % institutional investors (such as asset managers), 15 % banks and investment funds, 24 % insurances und the rest are retail investors and others.

III. COVER ASSETS, VALUATION AND LTV CRITERIA

As a principle, Swiss Pfandbrief loans are only given against a pledge of first rank mortgages on Swiss properties. Within PBZ the cover pool is managed by the member banks.

PBB has got an electronic cover pool. Mortgages are pledged to PBB by member banks through entry of the "cover proposal" into the electronic pool register, which all 239 member banks are linked with. The system immediately evaluates the member bank's "cover proposal", which is then reviewed by one employee and authorized by another. The valuation of PBB is independent of the valuation of the member bank. Substantial cover proposals are reviewed by the cover pool committee. Member banks can check on their screen, whether its "cover proposals" are accepted or refused for improvement.

PBB supervises the cover pool electronically. If coverage tends to become insufficient, an exception list is produced and the member bank will be informed automatically. Based on PfG member banks are obliged to increase coverage in case of impaired or non-performing mortgage loans or if total interest payable of the Pfandbrief loans is smaller than the total interest receivable on the pledged mortgages.

The cover pool of PBB consists of more than 110'000 individual mortgages all over Switzerland, which provides a good diversification. 95 % are residential and only 5 % commercial properties.

The PfG defines the maximum loan to value (LTV) of two thirds (Art. 5 PfG) and the valuation principles, which are detailed in the valuation regulations and approved by the federal council. FINMA can ask for a reassessment of the collateral if its market value or other economic conditions have deteriorated substantially.

External audit firms audit the annual reports of member banks and Pfandbrief institutes and the compliance of member banks' cover registers with the PfG. The auditors must report their findings to FINMA.

In total about 9 % of all Swiss mortgages are financed through Swiss Pfandbriefe.

IV. ASSET - LIABILITY MANAGEMENT

Cover principles

The PfG stipulates that the principal amount and interest payments of outstanding Pfandbriefe be at all times covered by an equivalent amount of loans to the member banks (PfG Art. 14). The Pfandbrief loans granted by Swiss Pfandbrief institutes to their member banks must be collateralised by eligible liens on real property (PfG Art. 19). The Pfandbrief institutes will only pay out Pfandbrief loans to member banks if the cover value of the cover register asset pool meets the criteria of the PfG.

Overcollateralisation

Additionally to eligibility and valuation principles (LTV legally at maximum 2/3, in reality less than 50 %), the cover value of the cover register assets have to exceed the Pfandbrief loans given to member banks by 8 % within PBB und by 15 % within PBZ. The higher percentage of PBZ compensates the fact that PBZ does not have an electronic cover pool register.

Additional Risk Limits

Swiss Pfandbriefe are issued in individual series which must match the repayment profile of the Pfandbrief loans to member banks, eliminating interest rate and funding risks. Currency risk does not exist as both the loans to member banks and the Pfandbriefe are issued in Swiss Francs. Therefore there is no need for derivatives to hedge market risks. Liquidity concentration risk is limited by individual limits for each member bank. The investment policy for free assets limits credit and market risks on counterparty and portfolio level. All Swiss Pfandbriefe are part of the Swiss National Bank repo basket and can immediately be pledged against cash to any Eurex Repo member.

Growth of the Pfandbrief institutes is limited as the required capital must exceed 2 % of the total Pfandbrief issuance volume of the respective institute (PfG Art. 10).

Insolvency scenarios

In the event of the insolvency of a member bank, the Pfandbrief institute has a priority claim on the registered collateral (PfG Art. 23). The insolvency of a member bank does not trigger the acceleration of outstanding Pfandbriefe because the investors have no direct contractual relationship with the member bank. In this respect, the Pfandbrief institute functions as a buffer between the investors and the member banks. FINMA cannot delay payments on the Pfandbrief institute's claims, which are themselves backing the Pfandbriefe (BankG Art. 26, Abs. 1, h). Moreover, FINMA can demand the transfer of the collateral pool under its control and then act as fiduciary (PfG Art. 40) or arrange for a sale of the cover assets to other banks².

Timely payments on Pfandbriefe are ensured, even if one or several member banks default. First, the Pfandbrief institutes collect the interest on the member loans on a semi-annual basis while coupon payments on Pfandbriefe are annual. Second, the Pfandbrief institutes have own funds at their disposal and maintain a portfolio of liquid investments.

The insolvency of a Pfandbrief institute is highly unlikely as it could only occur if several member banks defaulted at the same time, combined with a severe deterioration of the cover pool. Moreover, FINMA is highly likely to use supervisory efforts to avoid a bankruptcy of a Pfandbrief institute. In the improbable scenario of bankruptcy of a Pfandbrief institute, Pfandbriefe would accelerate and Pfandbrief investors would rank pari passu among themselves on the proceeds of the asset sale (PfG Art. 29). Again, FINMA has the power to assume control of the respective cover pool and to act as fiduciary.

Risk-weighting

Switzerland implemented Basel II into national law and modified it to account for national specifics contained in the Swiss Capital Adequacy Ordinance (CAO). The CAO has three approaches to measure credit risks in banking books: 1) The Swiss standard approach, 2) the BIS standard approach and 3) the internal ratings-based approach. Under the Swiss standard approach Swiss Pfandbriefe have a 25 % risk weighting, while under the BIS standard approach they have a final risk weighting of 22 % (taking into account a risk weighting of 20 % and the multiplier of 1.1).

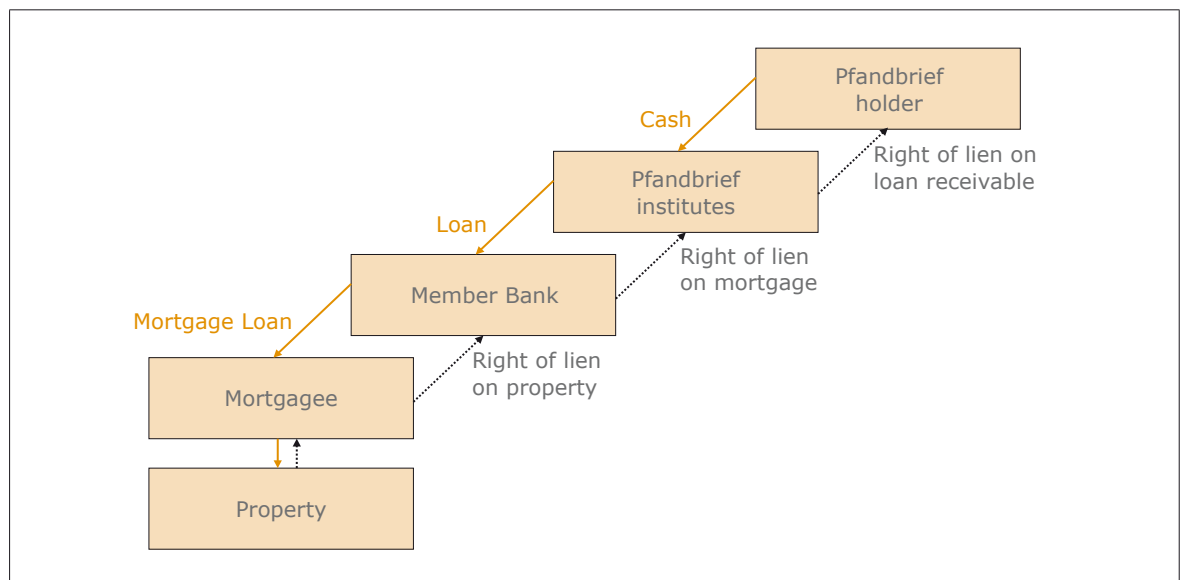
² In the early 1990s, Spar- und Leihkasse Thun, a member bank of PBB, no longer met regulatory capital requirements and was closed by the FINMA. Cover pool mortgages were sold to other banks and the proceeds were used to amortise the loans granted by PBB.

V. INVESTORS BENEFITS

An investor in Swiss Pfandbriefe benefits from

- > the special bank principle with no currency and no interest change risk.
- > the cover pool, which only includes mortgages on Swiss properties and thus excludes ship or airplane mortgages, derivatives, foreign mortgages etc.
- > the fourfold security which is 1) the creditworthiness of the Pfandbrief institute, 2) the creditworthiness of the member bank, 3) the creditworthiness of the proprietor of the property and 4) creditworthiness of the property itself.
- > in the case of PBZ: Explicit state guarantee for most of its member banks.
- > in the case of PBB: The value of the property is determined by PBB and not by the member bank.
- > the fact that since the establishment of the PfG in 1930 neither an investor nor a Pfandbrief institute have ever suffered a loss.

> CHART 3: THE SWISS PFANDBRIEF MODEL



Source: Credit Suisse AG

VI. FACTS AND FIGURES

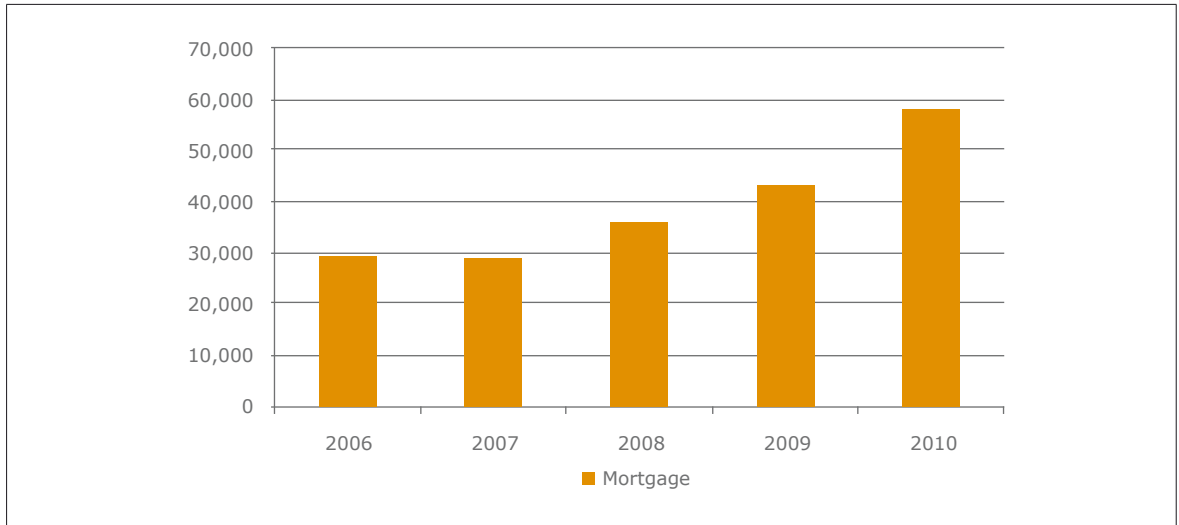
(CHF million)	PBB	PBZ
As of	31.12.2010	31.03.2011
Swiss Pfandbriefe outstanding	46'197	24'028
Average interest rate for outstanding Pfandbriefe (%)	2.355	2.649
Balance sheet total	47'904	25'332
Free Assets	1'158	644
Equity capital (Pfv Art. 18)	1'073	790
Moody's rating	AAA (stable)	AAA (stable)

VII. CONTACT ADDRESSES

For PBB: Pfandbriefbank schweizerischer Hypothekarinstitute AG
Nansenstrasse 16
CH-8050 Zürich (ZH)
+41 44 315 4455
www.pfandbriefbank.ch

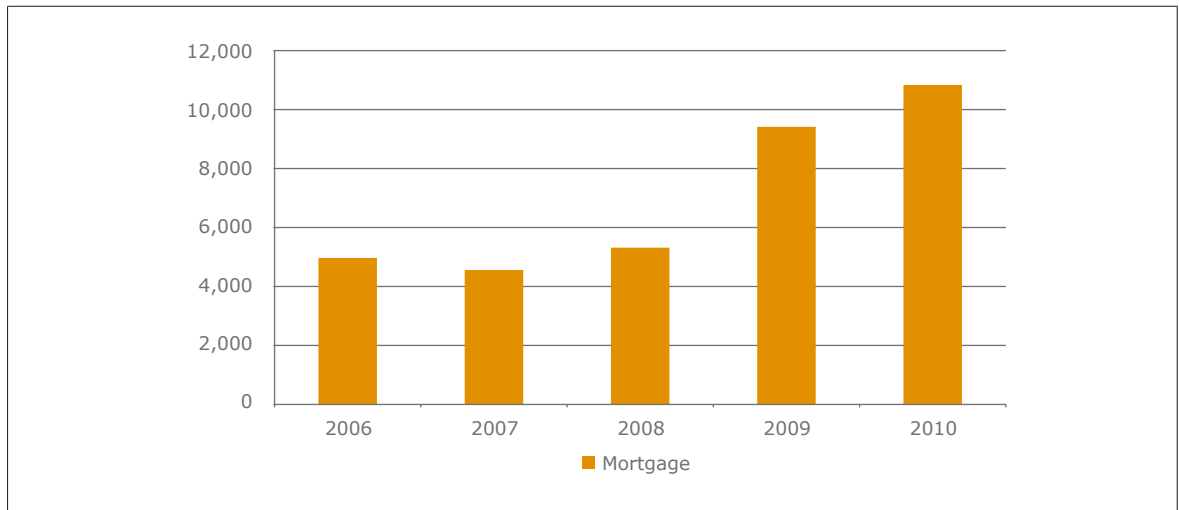
For PBZ: Pfandbriefzentrale der schweizerischen Kantonalbanken AG
Bahnhofstrasse 9
CH-8001 Zürich
+41 44 292 2778
www.pfandbriefzentrale.ch
www.cldg.ch (French)

> FIGURE 1: SWISS PFANDBRIEFE OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: SWISS PFANDBRIEFE ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC