

Fixed Income Research – Switzerland

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Issuer profile**Swiss Pfandbrief Institutions**

Debt securities issued by the two Swiss Pfandbrief institutions constitute one of the most important segments of the Swiss bond market. This report profiles both issuers and discusses credit aspects of these mortgage-backed instruments.

Issuance of Swiss Pfandbriefs limited to two institutions

The idea of creating securities to finance mortgage loans dates back to the 18th century. First-mortgage instruments issued against a particular proprietor, i.e. personal deeds of mortgage, were eventually replaced by mortgage securities in bearer form which made them easier to transfer and trade. In Switzerland, the rise of pension and insurance funds stimulated demand for safe investment instruments.

The Swiss Pfandbrief system was given its present form by the Federal Pfandbrief Act of 1930 (Schweizer Pfandbriefgesetz). Under this law, only two institutions are entitled to issue Pfandbrief securities in Switzerland: one Pfandbrief institution for cantonal banks (Pfandbriefzentrale der schweizerischen Kantonalbanken) and the "Pfandbriefbank" acting for all other Swiss mortgage lenders (Pfandbriefbank der schweizerischen Hypothekarinstitute).

Swiss Pfandbrief Act: priority on investor protection

The regulatory framework governing the Pfandbrief system as laid out in the Pfandbrief Act assigns absolute priority to protecting holders of Pfandbrief debt securities. To this end, a chain of safety provisions was established (see diagram on page 5). The provisions stipulate that obligations arising from Pfandbrief loans are backed not only by the real estate lien but also by the institutions issuing the Pfandbriefe, their member banks – with all their assets – and, in the final instance, also the primary mortgagee. In addition, the liabilities of most members of the cantonal banks' Pfandbriefzentrale are backed by guarantees of their respective cantons.

Balance-sheet management of the Pfandbrief institutions is subject to both the matching and cover principle which calls for every issue of Pfandbrief securities to be matched by Pfandbrief loans (Pfandbriefdarlehen) to the member banks of

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identical terms and conditions. With a cover of slightly above 100%, this structure also avoids any interest rate exposure for the Pfandbrief banks. The member banks are required to provide collateral for their loans in the form of mortgages, which are recorded in so-called “Pfandregister” (mortgage registers). While the member banks physically retain them on their balance sheet, the registers are checked as part of the member banks’ annual audits.

Independence of Pfandbrief institutions prevents conflicts of interest

The activities of the Swiss Pfandbrief institutions are restricted by law to their function as issuing vehicles of Swiss Pfandbrief securities. In our view, this provision entails one of the principal strengths of the Swiss Pfandbrief system. The two institutions are not entitled to engage in any other, potentially more risky banking activity, e.g. direct mortgage lending¹. Following from that, there is no incentive for the Pfandbrief institutions to compromise on any aspects of Pfandbrief collateral. Setting the loan to mortgagable value ratio to a conservative 2/3 will, by itself, not ensure quality of the mortgage collateral since, as is well known, assessments of property values will lead to a variety of results depending on the method employed.

By contrast, in the German and Danish Pfandbrief systems public and private mortgage banks issue Pfandbrief securities themselves. Apart from the fact that, in general, the mortgage collateral will be less diversified, particularly in geographical terms, this practice requires a specially stringent monitoring of the mortgage collateral by external, independent auditors. The table on page 6 and 7 presents features of the Swiss Pfandbrief bonds compared to similar instruments issued in other European countries.

Pfandbriefs compared to mortgage-backed securities

Asset-backed or more specifically mortgage-backed securities (MBSs), which have become a major asset class in today’s financial markets, are not directly comparable to Swiss Pfandbrief bonds. As a general rule, an MBS is backed by a separate pool of mortgages whose cash flow is applied to service the debt instrument. Even though any specific Pfandbrief issue is also matched by precisely identifiable mortgage-backed Pfandbrief loans, it shares its backing with all other series issued by the Pfandbrief institution, i.e. it is supported by the entirety of the mortgage-backed Pfandbrief loans to member banks. If, in the case of an MBS, the collateral and possibly supplementary credit enhancements (e.g. letters of credit) fell short of meeting creditors’ claims, there would be no recourse to assets of banks that arranged the transaction or granted the original mortgage loan.

Current real estate crisis does not affect the quality of Pfandbrief securities

The 1990 downturn in the Swiss real estate market has been the first real test of the solidity of the Pfandbrief system since the collapse of property prices during the Second World War. According to figures published by the Swiss Federal Banking Commission, between 1991 and 1996 Swiss banks accrued losses of CHF 42 billion in domestic lending. The Pfandbrief institutions, however, have not been affected by this crisis. Pfandbrief issues are used primarily by the cantonal banks as well as regional and Raiffeisen banks to refinance their mortgages on residential property². Their loan business is largely retail-oriented, and losses have been

¹ For Pfandbrief institutions direct mortgage lending is insignificant, constituting only an investment possibility for reserve assets. The Pfandbriefbank’s direct investments in mortgages, for example, amount to just CHF 33 million, or 0.2% of total assets.

² This is also reflected in the composition of the underlying collateral for Pfandbrief securities, more than 90% of which are mortgages on residential property.

substantially lower and hence could be absorbed by the member banks. Neither of the Pfandbrief institutions had to report any defaults on Pfandbrief loans. While on-going consolidation in Swiss banking has resulted in a diminishing member base and Pfandbrief issue volumes have not been growing, the two Pfandbrief institutions remain broadly based and enjoy solid backing.

Conclusion:
Triple-A quality

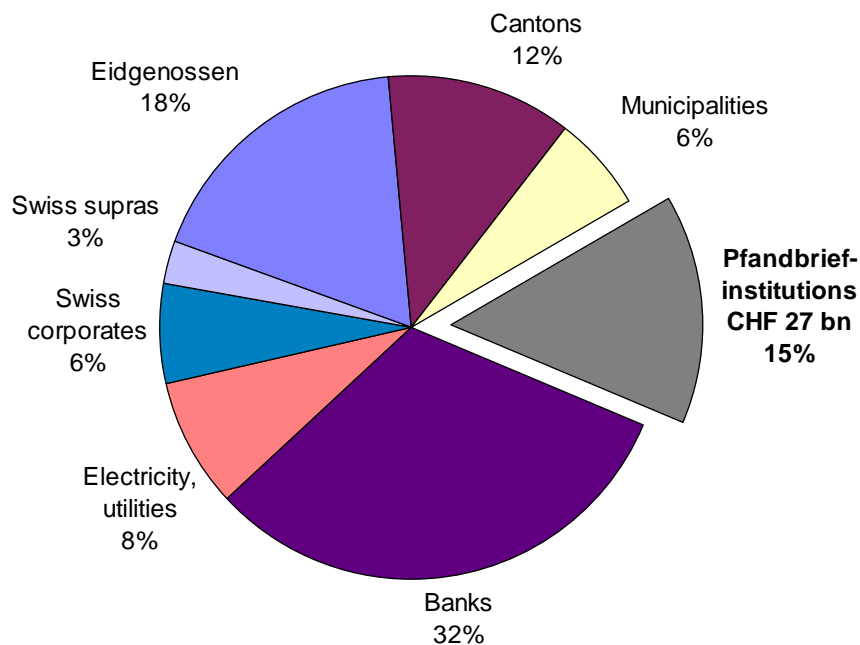
In our opinion, Pfandbrief securities provide the safest investment option in the Swiss capital market besides bonds issued by federal or cantonal governments. Given the safety net in the Pfandbrief system, real risks would only arise if the entire Swiss banking sector was affected by a system-wide crisis. But even in this worst-case scenario, the effect would most likely not go beyond a delay in payments to bondholders, and any loss would be minimal on account of the pledged collateral. It is no surprise that according to cantonal law Pfandbrief bonds qualify as so-called “mündelsicher” investment instruments, meaning they qualify for inclusion in trust portfolios of orphans and widows. We work on the premise that Swiss Pfandbrief securities, by analogy with the officially rated German Pfandbrief bonds, be awarded a triple-A rating by the credit rating agencies.

Bonds and private placements of Swiss Pfandbriefbanks

(CHF million)	Bonds	Private placements	Total
Pfandbriefbank	11,489	1,679	13,168
Pfandbriefzentrale	15,735	1,340	17,075
Total	27,224	3,019	30,243
Average amount issued	CHF 254 mn	CHF 60 mn	
Spread to Swiss government (Eidgenossen)			
- w/o early redemption	20 bp		
- callable instruments	48 bp		

Source: CSFB data, status July 1997

Swiss Franc domestic bonds by type of issuer



Total amount issued: CHF 183 bn.

Source: CSFB data, status 27 May 1997

Yields on Pfandbrief securities approx. 20 basis points above Eidgenossen

Yields of non-callable Pfandbrief bonds are an average of approx. 20 basis points above the curve for Swiss government bonds. Spreads on some of the more recent issues with coupons closer to current market levels are slightly tighter.

Callable bonds offer higher returns. The coupons on these securities tend to be so high that there is a high probability of early redemption. The yield to this early call amounts to an average of 48 basis points over comparable Eidgenossen bonds. Active trading opportunities might, however, be limited by the fact that there is no liquid market in these instruments. The chart on page 8 shows a yield/maturity diagram of listed Swiss Pfandbrief bonds.

Credit spreads of the cantonal banks' Pfandbriefzentrale and the Pfandbriefbank are much the same on average. While our analysis revealed differences of 1–2 basis points across all maturities, the specifics of the respective securities (coupon, maturity, call features, issue size) have by far the greater impact on spreads.

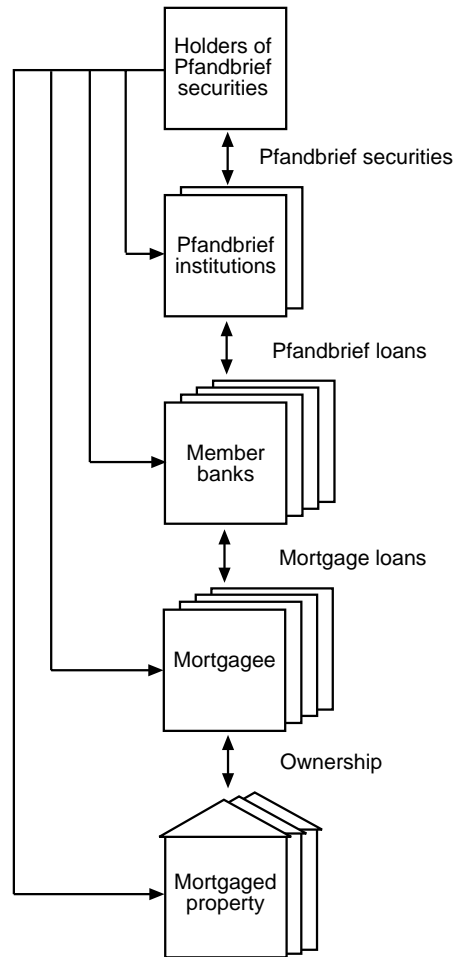
Larger issues are more liquid

Liquidity is becoming an increasingly important investment criteria, especially among institutional investors. Thus, the trend towards larger issues has also had its effect on the issuing activity of the Pfandbrief institutions. The 3 1/2% Pfandbriefbank series 337, due 27 March 2007, which through reopening has just been increased to a total amount of CHF 790 million, is now one of the largest issues in the Swiss Franc bond market. Another recent issue is the CHF 500 million 4% Pfandbriefzentrale series 306, due 28.2.07.

The fundamental handicap of Swiss Pfandbrief securities remains the fact that, as any domestic bond in the Swiss market, they are subject to Swiss withholding tax (Verrechnungssteuer). In that respect, for international investors they are somewhat less attractive than, for instance, German Pfandbrief bonds.

Safety provisions for Pfandbrief securities

Asset base supporting Pfandbrief claims



Source: Rules and regulations governing the issuance of Swiss Pfandbrief securities

Swiss Pfandbrief Institutions

Swiss Pfandbrief system compared to mortgage bonds/Pfandbriefe in other European countries

	Switzerland	Germany	France	Denmark
Name of debt instrument	Schweizer Pfandbriefe	Pfandbriefe	obligation foncières obligations communales	Realkreditobligationer
Amount issued (CHF bn)	CHF 29 bn	CHF 758 bn	CHF 62 bn	CHF 248 bn
Type of debt instruments	Pfandbriefanleihen	Hypothekpfandbriefe öffentliche Pfandbriefe	obligations foncières obligations communales obligation pour prêts à la navigation	Realkreditobligationer
Credit ratings	No official ratings	Rated instruments typically carry a triple-A from Moody's and/or S&P	Senior debt, i.e. mortgage bonds are currently rated A3/A. In the aftermath of the government rescue action (see below), they are watchlisted for a possible upgrade	Rated instruments typically with double-A ratings (Moody's). If issuer is owned by commercial bank, rating of mortgage bonds is one notch above bank rating
Issuing entities	2 specialized Pfandbrief institutions: Pfandbriefzentrale for cantonal banks Pfandbriefbank for all other Swiss banks	27 mortgage banks (of which 24 are "pure" mortgage banks and 3 "mixed" mortgage banks)	Crédit Foncier de France (CFF): a specialized financial institution	9 mortgage credit institutions; thereof 6 with capital centers; 3 without capital centers (explanation capital centers see below)
Legal framework	Swiss Pfandbrief Act (Pfandbriefgesetz)	German Mortgage Banking Act	Specialized financial institution under the terms of the French banking law of 1984	Danish Mortgage Credit Act
Ownership structure	Pfandbriefzentrale owned by cantonal banks; Pfandbriefbank's shares are held by approx. 200 private sector Swiss banks	Pfandbrief business conducted by private banks and public sector banking institutions (e.g. Länderbanken). Some private banks are owned by larger commercial banks	Formerly privately owned with management appointed by government; in Dec.1996 taken over by state authorities after losses in property lending had wiped out its shareholders' equity	The leading mortgage credit institutions are controlled by commercial banks
Permitted business activities	No banking activities other than issuing Pfandbrief bonds and mortgage-backed lending to Swiss banks	Public sector lending within EU; residential and commercial mortgage lending within EU. No trading or general banking activities permitted	Activities restricted to original mission, i.e. mortgage lending, lending to local government and national authorities. No retail deposit under 2 yrs. Commercial real estate through subsidiaries	Residential and commercial real estate lending. Public sector lending is permitted but not significant
Maximum bank lending levels (Loan-to-value threshold)	Not applicable since Pfandbrief banks are pure funding vehicles only and do not undertake any direct bank lending	For "pure" mortgage banks: (i) public sector lending unlimited (ii) additional lending of an aggregate 20% of mortgage loans over 60% LTV ⁽¹⁾ portfolio. No lending restrictions for "mixed" mortgage banks	(i) public sector lending unlimited (ii) maximum mortgage lending is 60% LTV ⁽¹⁾ unless higher LTV simultaneously guaranteed by state or local authorities	Residential mortgages can be 80% LTV ⁽¹⁾ (while social housing can be 80-93% LTV), industrial and commercial loans are up to 60% LTV

Source: Regulations governing Swiss Pfandbrief Banks; non-Swiss data adapted from Moody's Investor Service, Special Comment on German Pfandbriefe of June 1996

Swiss Pfandbrief Institutions

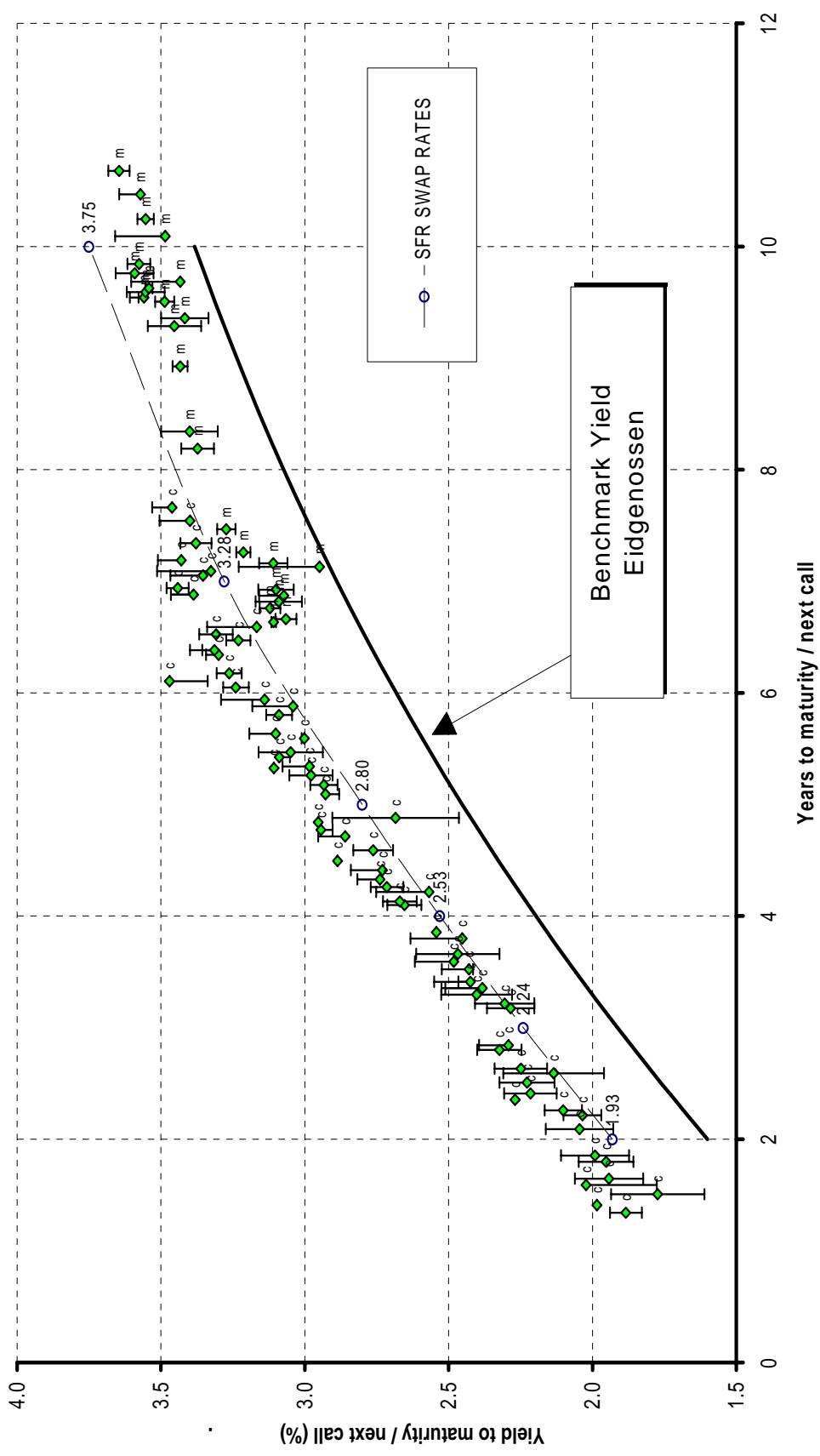
Swiss Pfandbrief system compared to mortgage bonds/Pfandbriefe in other European countries (continued from previous page)

	Switzerland	Germany	France	Denmark
Specific allocation of assets to separate asset pools	Yes; assets of the 2 Pfandbrief institutions effectively form a collateralized asset pool. Due to the limited scope of their activity, they possess virtually no other assets	Yes; assets which form the collateral for Pfandbrief issues are booked as a separate asset class in the balance sheet.	No	Mortgage loans would be earmarked in specific groupings known as "capital centers"; no specific allocation for banks w/o capital centers
Qualifying threshold for inclusion in collateral	66.7% LTV ¹⁾ for mortgage loans	60% LTV ¹⁾ for mortgage loans	None	None
Allocation / approval to asset pool by:	The Pfandbrief institutions themselves	An independent trustee	Not applicable, since there is no separate allocation to an asset pool	The mortgage institution itself (only applicable for banks with capital centers)
Who holds and administers collateral?	Member banks physically keep collateral and mortgagees are not notified. Mortgages are recorded in a "Pfandbrief registry" and pledged to the Pfandbrief banks ("Registerpfandrecht")	Mortgages held and administered by mortgage banks	Mortgages held and administered by CFF	Mortgages held and administered by mortgage banks
Supervision of issuer and specific debt instrument	Eidgenössische Bankenkommission (Swiss banking authorities) and independent auditors	Bundesaufsichtsamt für das Kreditwesen and an independent trustee for Pfandbriefe / asset pools	Commission bancaire; no additional/separate monitoring of debt instruments	Finanstilsynet (the Danish Supervisory Authority)
Protection against mismatching	Terms of Pfandbrief securities (amount, maturity) are identical to terms of loans to member banks. Pfandbriefgesetz prescribes Gleichgewichtsprinzip (balance principle) and Deckungsprinzip (cover principle)	Interest and maturity matching required under the Mortgage Banking Act. This applies to the Pfandbriefe and the respective asset pools. The mortgage banks themselves are not restricted in retaining "open" interest rate positions	None	Yes; measures known as "balance principle"
Are these debt instruments bankruptcy-remote?	Yes; as special purpose vehicles, Swiss Pfandbrief banks would not directly be affected by the bankruptcy of a member bank	No; bankruptcy of issuing entity would affect payment stream even if investors might not suffer any losses in the end	No	No; bankruptcy of issuing entity would affect payment stream even if investors might not suffer any losses in the end
Franchise vulnerability due to change(s) in legislation	Low. Generally franchise more under threat from market forces as there are alternative, potentially more economical refinancing strategies available for some of the bigger member banks	Low for private mortgage banks. Generally, franchise more under threat from market forces	As illustrated by the loss of its monopoly for the distribution of subsidised mortgages (which lead to the major crisis 1996), changes in the legislation had a profound impact on CFF	Low. Generally franchise more under threat from market forces

1) LTV: Loan-to-mortgageable-value

Source: Regulations governing Swiss Pfandbrief Banks; non-Swiss data adapted from Moody's Investor Service, Special Comment on German Pfandbriefe of June 1996

Rendite / Laufzeitdiagramm Anleihen der Schweizer Pfandbriefinstitute



Source: EBS price data 23.7.97, CSFB models

Yield calculation: m - Yield to maturity (YTM); c - Yield to next call (YTC), if YTC < YTM