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Securitisation

Switzerland: Trends & Developments
Baker McKenzie

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Trends and Developments

Contributed by Baker McKenzie

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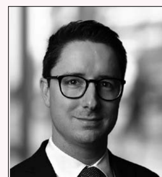

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Limited Returns and Risk Mitigation in Financial Markets as Driving Factors

The Swiss National Bank determined for 2017 that 50% of all retail mortgage loans in Switzerland are not sustainably financed should the interest rates on such mortgages increase to 5%. Swiss banks have roughly CHF1,000 billion in mortgage loans outstanding. While the bank balance sheets appear less exposed to an increase in interest rates as such, there may be substantial risks resulting from future losses in the mortgage market. The Swiss Financial Market Supervisory Authority (FINMA) mentioned that they are most concerned with the quality of debtors, in particular with respect to investment properties. Whereas prices for investment properties are still rising, rents are decreasing and vacancies are at a high level with continued construction going on. Against this background, FINMA requires Swiss banks to be able to absorb the losses and has ordered capital surcharges.

Based on the above, there are good reasons from a purely banking perspective to set up structures that allow, on the one hand, the reduction of the risks and, on the other hand, the improvement of the capital situation. This is, for example, achieved by transferring sub-participations in underlying loan portfolios to an investment fund. One of the key elements is to make sure that there is no adverse selection regarding the loans in which the sub-participation is given on the side of the bank. This requires proper management by an outside third-party fund manager. Another way to achieve the transfer of risks is the use of credit-linked notes and other synthetic balance sheet securitisation structures that have achieved some popularity in recent years. These ways of improving the capital structure help to make the banks more resilient against any downturn, but they do not solve the fundamental problem of a tendency of overheating in the Swiss real estate market. Should there be an increase in interest rates, and should there be a drop in property prices, this may substantially hit those seeking to invest in the property markets as well to keep up their returns – pension funds and other social security institutions.

The Swiss regulator has so far not taken any steps to introduce limiting regulations, but has limited its actions to motivating self-regulatory actions and flagging the topic.

Platforms Offering Securitisation Features

There is already a number of lending platforms active in Switzerland that function as mere market places for lenders

and borrowers. In terms of volume, straight debt without any security attached has been the most important product, namely when lending to communities or other public sector participants.

There are more and more offerings that offer investments that are secured by assets. There are a number of firms offering factoring; however, this is financed by a pool of third-party investors, which mainly come from the institutional investors space. Further, there are also attempts to provide securitised debt through platforms. Finally, there are several serious attempts to allow the tokenisation of assets so that they can more easily be transferred but also serve for securitisation.

Refinancing Through Securitised Bonds
The last few months has seen the closure of high-yield and the narrowing of other debt markets, making the access of corporate borrowers to the debt markets substantially more difficult. Meanwhile, the equity market also shows substantial weaknesses. Should this trend continue, there might be a tendency to refinance currently unsecured debt with asset-backed issuances. This may allow refinancing at still acceptable rates.

Legal Developments – EU Regulations and FinSA
Switzerland has no separate code that deals with securitisation transactions. Such transactions are structured with the means general legislation makes available. Since transactions with Swiss originators are frequently structured through SPVs or trusts abroad or lead otherwise to the issuance of securities also marketed outside of Switzerland, EU regulations need to be complied with. That notably concerns the PRIIPS Regulation (EU 1286/2014) on key information documents for packaged retail and insurance-based investment products, so-called PRIIPs, and MiFID II (Directive 2014/65/EU on markets in financial instruments).

There is little doubt that securitised bonds or notes are PRIIPS. The consequence is that if these securitised products are marketed to retail investors as defined in the PRIIPS Regulation, a so-called key information document (KID) needs to be established and made available before a retail investor invests into the relevant product. The KID is a technical document disclosing risks and returns. It also needs to be updated when changes occur. Only larger issuers with repeated issues may reasonably be in a position to comply with the requirements regarding the KID.

That means ultimately that issuers have a desire to avoid a KID. This requires that the securitised bond or note is not sold to retail investors in the European Economic Area (EEA). When including the respective selling restrictions, it has to be taken into account that the PRIIPS regime and definitions deviate from the regime of the Prospectus Directive. Therefore, independent sets of legends have been developed and should be complied with. Also, the qualified investor segment created by the Prospectus Regulation will not do the job – a corresponding PRIIPS legend will still be required. Swiss banks should avoid selling indirectly to their EEA-domiciled retail customers. Whether and under what circumstances the PRIIPS Regulation would apply is uncertain, but it is nevertheless worth not taking any risk in that regard.

Further, the MIFID II product governance rules require MIFID II firms that act as manufacturers or distributors of financial instruments to maintain a particular approval process for each financial instrument and to identify target markets of investors that are compatible for such instruments. They need to assess the risks relevant to the target markets to make sure that the instrument and the distribution strategy fit the target markets. Often, there will be a desire to limit the disclosure requirements under the product governance rules of MiFID II. To do so, these firms may limit their identified target market to eligible counterparties and professional clients and they could use high denominations. For that purpose, selling restrictions have been developed which must be included in the respective offering materials.

In Switzerland, the Financial Services Act (FinSA) has finally been approved by the Parliament, but it will only be put into force by the Federal Council once the corresponding ordinances have been finalised. Consultation regarding the ordinances is going on at the moment. Currently, the FinSA is expected to enter into force as per 1 January 2020. The FinSA also contains provisions that require the preparation of a base information sheet similar to the KID for debt instruments with a derivative character. Currently, it is expected that the ordinance will exclude quite a number of debt instruments from the KID requirement, including convertible bonds if the underlying share is issued by the same issuer or an issuer of the same group of companies, bonds with interest rates linked to reference rates, inflation protected bonds, bonds with make-whole features (a call provision that allows the issuer to pay off all or part of the debt early), bonds with put or call options, and zero-coupon bonds.

Although the list is quite comprehensive, there remains uncertainty as to what extent products in the area of securitisation do or do not fall under the Swiss KID regime. Despite the tendency to exclude a large number of debt instruments

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from the KID requirement, it can be expected that one of the consequences of the introduction of this requirement will be that many issues will exclude the sale to retail investors in order to avoid the preparation of additional documentation.