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PRIVATE EQUITY

CRACKING THE CONTINENT

BY JOHN E. MORRIS

IRELAND

THE

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SECURITIZATION SWISS STYLE

Securitization in Switzerland has grown slowly but surely in recent years. Four lawyers who specialize in this area discuss where the market now is and how it is likely to develop.

With its strict banking regime, lack of specific laws and relatively small asset pool, Switzerland is not the most obvious country in which to find a growing securitization market. However, thanks to a few innovative lawyers and forward thinking companies and financial institutions, some interesting deals have been done over recent years.

Joff Wild asked four Zurich-based lawyers whose firms are at the heart of what is happening to explain the issues involved. We are grateful to Thomas A. Frick, a partner with Niederer Kraft & Frey, Walder Wyss & Partners senior associate Johannes Bürgi, Beat Kühni, a partner with Lenz & Staehelin, and Homburger partner René Bösch, for the insight they gave.

Joff Wild: How would you describe the state of the Swiss securitization market right now?

René Bösch: The Swiss securitisation market has been comparatively slow in recent years. After certain promising developments in 1997 and 1998, there have only been a handful transactions closed each year since then. In the last 12 to 18 months we have

seen a number of interesting deals coming to the market, but the expected boom has not yet materialized. In my view, the predominant number of transactions still relate to repackagings which are privately placed.

Beat Kühni: While most of the deals still consist of receivables backed securitizations, the market produced further landmark transactions recently and we have now established precedents in Switzerland with respect to most asset classes. Ways have been found to put in place appropriate deal structures that address underlying tax, regulatory and other aspects. Although it is true that the market was slow in recent years, we have seen that there is a Swiss securitization market – and arguably potential for future growth. Large corporate borrowers and banks are following the market quite closely and are considering what preparatory steps need to be implemented to allow an eventual securitization of their assets.

Johannes Bürgi: Securitization is an established financial technique in Switzerland, albeit one used sporadically.

In our experience, it is used either to meet the special needs of an originator in a one-off transaction or when market conditions for a placement of asset-backed or asset-linked securities seem particularly attractive. In recent years, Switzerland has seen some interesting and particularly innovative transactions.

Thomas Frick: I agree with my colleagues that the market for securitization transactions currently seems to be set on a slow, but on the whole rather steady growth. The financial technique of securitization is meanwhile well established in Switzerland, although it is not used very often. The deteriorations of the credit ratings of certain Swiss companies have made securitization transactions more attractive in particular for the purpose of long-term funding of companies.

How has the securitization market developed over recent years?

TF: The use of securitization techniques developed rather slowly in Switzerland. In the beginning, securitization had the reputation of being an over-complex and expensive transaction. However, there is now a

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steady growth of the market with a current average of between five and 10 transactions per year, although a number of those are private placement transactions only. Securitized assets include credit card receivables, car dealer loans, small business loans, mortgage loans, commercial loans, sport marketing rights and others.

RB: Securitizations still have the stigma of being onerously complex and costly. Therefore, despite some promising developments in the late 90s and despite the flurry of German mortgage-backed bonds (*Deutsche Pfandbriefe*) issued in the Swiss markets since 1998, the market is still sluggish. Although this year we have seen two interesting transactions making it to the market (Lehman Brothers' \$800 million commercial mortgage-backed securitisation and CSFB's Chalet Finance), I am still not very optimistic about the near term future for the Swiss market.

JB: Though the number of transactions remains rather small, new and exciting asset classes are being securitized. During the last 24 months, for example, our firm has been able to advise clients on commodity inventory, commercial mortgage loans and sport marketing rights transactions that have been added to the list of successfully securitized assets.

2003 has seen the first Swiss CMBS transaction (Eiger Trust) with the securitization of loans financing a portfolio of real estate which was sold two years ago by Swisscom. The vendor remains the largest tenant. The transaction permitted high LTVs and attractive funding costs, thereby establishing an interesting alternative to straight bank debt. In June 2003, the first Swiss RMBS transaction (Tell) came to a successful end and investors were repaid on the expected maturity date.

In July 2003, Credit Suisse closed a synthetic CLO transaction, Chalet, whereby Chalet Finance 1 plc, from



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Ireland, issued different tranches of fixed-floating rate Swiss Residential Mortgage Linked Notes denominated in US dollars, euros and Swiss francs.

In November 2001, Fédération Internationale de Football Association (FIFA), the world governing body of soccer, completed what is believed to be the world's first securitization of sports marketing rights. In a two-step transaction, FIFA sold receivables under sponsorship agreements with the sponsors of its international soccer events, including the 2002 FIFA World Cup Korea/Japan and the 2006 FIFA World Cup Germany to a Swiss SPV. The transaction was privately placed and the international aspects of this transaction provided special challenges. The key events and all sponsors are located in countries different from FIFA and this had to be taken into account in the tax and the

legal analysis, particularly in the area of competition law. An additional challenge was presented in the legal review of the underlying assets themselves. Sports marketing rights, their exploitation and the exclusivity linked with the rights are analyzed differently in different jurisdictions.

Walder Wyss & Partners had a major role in all of these transactions.

BK: I think it is worth reminding ourselves that the first milestones in Switzerland were set only in the late 90s when the first listing of asset backed securities occurred and the first public residential mortgage backed securitization project was launched (Tell). Although bankers and lawyers alike expected these Swiss *primeurs* to set the stage for an increasing number of transactions, it has not really happened. However, there has been a slow but steady flow of subsequent launches involving new asset classes that indicate a tangible interest in alternative financing, risk and capital management tools in the Swiss market. In addition to the transactions mentioned by my colleagues, UBS' launch of its first synthetic CLO transaction in June 2000 (HAT) and Zürcher Kantonalbank's launch of the first program for repeat securitizations in November 2001 (Swissact) come to mind. In particular, the steady addition of new asset classes is in my view an encouraging indication that the market is alive.

What are the major factors behind this slow growth?

BK: With a comparatively small asset pool, the potential for growth in the Swiss market is necessarily limited if compared with other European countries considering the relatively high transaction costs for securitization transactions in general. We can therefore assume that there will be more pressure for further standardization in Switzerland to cope with high costs relative to the size of the securitized

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portfolio of assets. On the other hand, the securitization market has also been dampened by the overall downturn of the markets during the last few years and low interest rates with little room for attractive spreads.

TF: I think that the slow development of securitization in Switzerland is also due to the availability of sufficient alternatives such as *Pfandbriefe*, to the usually comparatively high credit rating of Swiss companies and in particular to the low interest rates for loans in Switzerland, which make other sources of funding available. Furthermore, banking secrecy and data protection laws and the restrictive rules on the acquisition of Swiss real estate by foreign persons (the so-called *Lex Friederich*) may hinder the free transferability of certain loans.

JB: It seems to me that the principal

motivation for securitization transactions has shifted over the last 24 months from balance sheet management to funding transactions. Widening spreads and the deteriorating credit ratings of some companies have made securitization more attractive. In particular, bank loans are often seen by corporate borrowers as too risky to meet medium to long term funding needs, probably because borrowers may reconsider their risk appetite in view of standard early termination triggers for breaches of financial covenants or material adverse changes in their financial situation.

RB: Like my colleagues, I believe that a combination of factors have caused the sluggish development of the Swiss securitization market: the low cost of borrowing (low interest rates) compared to the EU or the US; the

limited liquidity; little to no legislative support for securitizations (compared, for instance, with Germany); an unfavorable tax environment (issuance and withholding taxes); stringent privacy, data protection and bank secrecy laws; and uncertainty surrounding Basel II.

René mentions the lack of legislative framework for securizations in Switzerland. Can you talk about this in a little more detail?

RB: Contrary to other countries, such as France and Germany, there is little legislative support for securitizations. While there have been some small positive trends in the Swiss tax environment, at least with respect to thin capitalization rules, the major limiting factor is still the levy of Swiss withholding taxes on interest payments by a Swiss issuer of notes or bonds. In

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1997 a liberalization on the ownership of commercial real estate by foreigners was implemented which now supports the securitization of commercial real estate, but restrictions with respect to residential mortgages remain in place.

JB: Many of the legal issues depend on the specific asset class being securitized. The assets need to be legally analyzed in depth. In general, there are no legal issues which have a severe negative impact on securitization transactions. For instance, under Swiss contract law no notification of the debtor is necessary to perfect the assignment (sale) of the receivables.

Now that thinly-capitalized SPVs have been accepted by the tax authorities, a Swiss corporation (*Aktiengesellschaft*) can be used as a pay-through, on-shore SPV. Alternatively, investment funds could be used as pass-through SPVs, but investment funds are subject to the Investment Fund Act and are supervised by the Federal Banking Commission.

Standalone SPVs outside Switzerland have proved to be difficult because of the tax regime applied by the Swiss federal tax authorities. Still, they have been used successfully in several transactions.

TF: The tax authorities may be prepared to accept thin capitalization of a Swiss SPV, so that it only has to pay nominal taxes. Securities issued by a Swiss issuer are subject to issue stamp duty and interest paid is subject to 35% withholding taxes (which can be fully reclaimed by Swiss tax payers and may be partially reclaimed by foreign parties under applicable double taxation treaties). However, under certain conditions, tax authorities will not consider the use of offshore entities as issuers as abusive tax evasion. The tax authorities assess the transactions on a case-by-case basis. It is, therefore, necessary (and possible) to obtain an advance tax ruling.



Beat Kühni is a partner in the banking and capital markets and the mergers & acquisition group of the Zurich office of Lenz & Staehelin. He studied law at the University of Berne, Switzerland, and is a graduate of the LL.M. program at the University of Chicago Law School (1998), USA. Beat Kühni specializes in the area of asset-backed securitization transactions and related areas of law. He has been involved in various transactions including commercial and residential mortgage-backed securitization projects and advises rating agencies, banks and originators.

The Federal Banking Commission has approved several transactions involving Swiss banks. As there are no general guidelines, each transaction of a Swiss bank must be submitted to the Federal Banking Commission for prior individual approval. In its decisions up to now, the Commission has confirmed that the securitized assets will no longer be taken into account for capital adequacy purposes (provided there is a full and bankruptcy-proof transfer of credit risk), that the SPV will not be deemed a regulated entity and will not need to be consolidated by the originator and that the originator may perform certain additional functions and take on obligations, such as swap counter party, credit enhancements, clean-up-calls up to 10% of the securitized assets, and so on.

BK: While it is true that there is little legislative support for securitization in Switzerland, I think that overall the legislative framework in Switzerland

has proven to be sufficiently flexible to facilitate different transaction structures and asset classes.

As René mentioned, the major limiting factor still is Swiss withholding taxes although suitable structures have been found to cope with that. With regard to receivables backed transactions, the still prevailing asset class, investors and borrowers will have to consider that the assignment of future receivables is not bankruptcy remote under Swiss law.

Lastly, legislative competencies on the cantonal (state) level may add further complexity for some asset classes and will, particularly with regard to real estate transactions, increase transaction costs.

How is the market affected by Switzerland's banking laws?

TF: Securitization transactions may be attractive for Swiss banks not only for obtaining additional funds but also to obtain certain relief under capital adequacy provisions. However, banks will be restricted by Swiss banking secrecy in assigning claims against customers to a third party; prior approval of each customer is required. No approval is needed for synthetic securitization transactions in which customer names are not disclosed to a third party. The effects of Basel II on securitization transactions for Swiss banks are not yet clear but are being widely discussed. In October 2003, the Federal Banking Commission issued a circular on credit derivatives clarifying the capital adequacy rules applying to credit derivatives, which may help in particular synthetic securitization transactions.

RB: As Thomas says, Swiss banking secrecy laws make securitizations of retail customers' banking portfolios such as residential mortgages unduly burdensome. While customers may waive the secrecy protection, this is rarely done in case of retail customers. Therefore, market partici-

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pants have looked more to synthetic securitizations rather than traditional asset-backed transactions.

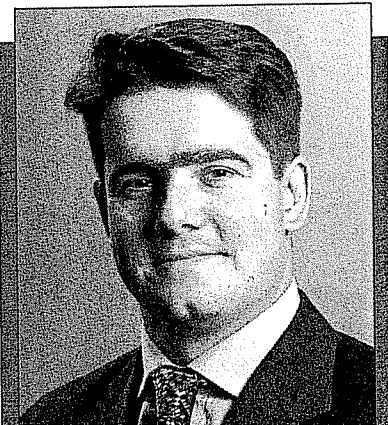
JB: Banks which do not want to get consent from customers for administrative or marketing reasons now have recourse to credit derivatives to transfer credit risk. However, only a few banks are rated (and few are expected to be rated above A) and few would be able to collateralize a funded transaction. It can therefore be expected that a limited waiver of the banking secrecy obligation will become standard in Swiss credit documentation, at least outside the private banking business activities.

The FBC guidelines Thomas mentions are based on the current Basel II proposal. Unfortunately, the rules deal only with credit derivatives and not with securitization transactions or alternative risk transfer more generally, which means that some uncertainty will remain.

BK: As my colleagues say, there are quite a number of regulatory issues to be looked at on a case-by-case basis, yet Swiss banking laws will typically not constitute deal breakers. Although Basel II will make traditional bank financing more difficult for some borrowers, this may not by itself translate into increased demand for securitization since investors will ultimately have to bear the underlying credit risk and will want to be compensated for that. In addition to the previously mentioned technical uncertainties surrounding Basel II, some market participants believe that Basel II will require banks to hold too much capital against asset backed securities when compared with other securities, such as corporate bonds. If this is the case, it will dampen the securitization market worldwide.

Can you describe any of the deals your firm has been involved in?

TF: Our firm has advised various orig-



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inators and financial institutions on all legal aspects of ABS transactions. However, I cannot comment on any of the individual deals our firm was involved in.

BK: The Zurich and Geneva offices of our firm regularly advise clients in securitization projects and have been involved in various transactions, including landmark commercial and residential mortgage backed securitizations. On the client side, we regularly advise originators, arrangers, rating agencies and banks alike. In terms of asset classes, most securitization projects on which we are advising still relate to (often privately placed) receivables backed securitizations and fairly complex securitizations of special equipment and machinery, including rolling stock.

RB: We have advised a number of Swiss originators or foreign financial

institutions in the structuring of transactions, particularly on regulatory and tax matters. Most of these transactions were private placements or transactions involving Swiss originators but being done outside of Switzerland.

JB: Our firm has been involved in virtually all of the public Swiss securitization deals. As examples, Walder Wyss & Partners has recently acted as Swiss transaction counsel in the \$2.4bn fully funded synthetic CLO (Chalet Finance 1) referenced to a portfolio of residential mortgage loans held by Credit Suisse as well as in the \$2bn follow-up transaction (Chalet Finance 2). In particular, our firm advised on all banking law aspects and led the discussions with the Federal Banking Commission. We were also involved as Swiss transaction counsel in the first Swiss CMBS transaction, a €699 million securitization (Eiger Trust) with WTF Holdings (Switzerland) Ltd as originator and Lehman Brothers Ltd. as arranger. The transaction refinanced bank loans which were used by WTF to finance the acquisition of a portfolio of real estate from Swisscom (closed in June 2003).

What kind of expertise does a Swiss law firm need in order to handle securitization work? How many Swiss firms have this expertise?

BK: Asset backed securitization projects require highly specialized legal advisers with significant practical experience. Of particular importance is immediate access to tax and regulatory expertise within the firm to cope with client needs and expectations, which requires the firm to build-up not only specialist know-how but also to have sufficient depth in terms of numbers of specialists available on short notice. I would think that only a handful of Swiss law firms have the necessary experience and size to meet these requirements.

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JB: Generally, securitization practice in Switzerland is a domain for outstanding legal experts. Clients require transaction-driven, responsive and outspoken lawyers with a solid economic background. Probably most importantly, a Swiss law firm will need a very solid track record as a main transaction counsel in securitization transactions. Ideally, the firm will also be familiar with rating agency procedures and requirements in such transactions. To my mind, given the relatively small size of the market only a very few Swiss firms have such relevant expertise or the potential to achieve such relevant expertise today.

TF: Any Swiss firm handling securitization work will need specialized expertise in the fields of taxation, listing rules, banking law (including the capital adequacy provisions of the Swiss Banking Law Ordinance) and readily available knowledge in the legal environment of the assets to be securitized (for example, mortgage loans and the respective security rights). Hence, only firms with both a particular focus on financial law as well as a broad range of in-house specialists available for other fields of law will be able to undertake securitization work efficiently. The number of sufficiently large and sufficiently specialized firms in Switzerland may be as small as half a dozen.

RB: A Swiss law firm needs to have specific experience in bank regulatory matters and in tax for advising on securitizations. Particularly in transactions involving Swiss banks the regulatory capital treatment is of utmost importance, requiring in-depth knowledge of the regulatory capital regime in Switzerland as well as with a view to developments internationally, in particular with respect to the Basel Committee on Banking Supervision. As can be seen from our discussion, in the future this will become even more important with



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the Basel II rules which we expect to be finalized by year end or early 2004.

What future do you see for securitization in Switzerland?

BK: Too many times various market participants have claimed to see indications for future growth only to witness another false start. Switzerland is and will remain a comparatively small market and is limited by the size of its asset pool. While there will always be niche players in the market for which securitization projects will be a significant part of their business, real and sustainable growth will in my view only materialize if standardization can be brought to a higher level to allow the use of these complex and costly structures for a variety of borrowers and asset classes. There is a solid interest from banks to optimize the risk/return profile of their credit portfolios and of large corporate borrow-

ers to seek alternative means of financing as traditional bank funding may become more difficult to obtain under Basel II.

JB: The market moves on but, except for trade receivables transactions, it is far from being standardized and most transactions are still one-off deals. Extensive experience of counsels retained is therefore crucial. It seems that Swiss banks and corporates are increasingly recognizing securitization as a powerful tool for asset and liability, risk and capital management and that this will increase the supply side of the market. The ability to list ABS securities on the Swiss Exchange makes these instruments acceptable to more than just institutional investors, thereby creating the necessary demand. The market has grown steadily and we expect that growth to now accelerate.

RB: We believe that because of the limiting factors we have discussed here, the Swiss securitization markets will continue to develop only slowly, at least for so long as interest rates remain low and credit spreads do not widen significantly. However, once the Basel II rules on securitization are fixed, we expect Swiss banks to become more active. All in all, however, we believe that the market will continue to be dominated by private transactions rather than public deals.

TF: Unless there is a drastic change in the market trend, we may expect to see a further steady growth of securitization in Switzerland. Key factors will be the regulatory environment (in particular the implementation of Basel II) and the development of refinancing costs for Swiss undertakings. Should refinancing costs continue to be low, the Swiss securitization market is not likely to enter a boom-phase, although in particular undertakings with a declining credit rating may have an increased interest in ABS transactions. ■