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Securitisation in Switzerland pauses amid the US sub-prime loan crisis

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After a dramatic increase in commercial mortgage-backed securities (CMBS) transactions in Switzerland during 2005, 2006 and the first half of 2007, the credit market crisis caused by the collapse of the sub-prime residential lending market in the United States also halted the advance of asset-backed securities (ABS) transactions originating in Switzerland. Significantly wider interest rate spreads for ABS have forced originators to defer new transactions until better market conditions develop.

This chapter provides an overview of Swiss legal and tax issues relating to ABS transactions.

Background

Securitisation found legal and commercial acceptance in Switzerland without the benefit of legislation or regulations specifically governing the issuance of ABS. The first public ABS transaction was Tell, a residential mortgage loan securitisation originated by a predecessor bank to UBS AG, which came to the market in 1998. Other public transactions followed: Swissact in 2001, a residential mortgage loan securitisation originated by the Zürcher Kantonalbank; and Eiger in 2003, the securitisation of a commercial real estate portfolio originated by the Swiss branches of two Bermuda companies controlled by a Lehman Brothers real estate fund. In the years since these transactions, CMBS conduit lending has become popular in Switzerland, including various pan-European CMBS transactions originated by Merrill Lynch, Deutsche Bank, Credit Suisse and Lehman Brothers in 2005,

Table 1: Transfer-related issues

Is a written transfer document required?	Yes.
Is a continuous assignment of receivables possible?	Yes, pursuant to a general assignment of all receivables of a specified type.
Is an automatic transfer of assets related to the transferred assets possible?	Generally yes, but there are exceptions.
Is the notification of debtors a condition to a valid assignment?	No.
Is a public filing required to perfect a security interest in transferred receivables?	No.
Is an optional public filing permitted to give notice of a transfer of receivables?	No.
Does a transfer preclude a debtor from asserting defences in respect of the receivable which it had against the originator against the transferee?	No. For example, objections or defences in relation to receivables which came into existence before the date of notification of the assignment can still be asserted.
Is there a limit on the amount of recourse (eg, credit enhancement; deferred purchase price) that the purchaser may have against the originator?	For tax purposes, the amount of recourse should not exceed 15 per cent to 20 per cent of the receivables balance.

2006 and 2007, which included Swiss loans that were refinanced through these transactions.

Historically, Swiss securitisation transactions have used a double special purpose vehicle (SPV) structure, in which a non-Swiss SPV issues securities to investors and loans the proceeds of those securities on an unsecured basis to a special purpose Swiss corporation, which in turn acquires the relevant assets and related security (eg, mortgages) and engages the originator to service them.

The Swiss Federal Tax Administration (FTA) now seems to be reconsidering the basis on which it will recognise that an originator is exempt from an obligation to pay source withholding tax on the interest paid on ABS. The most recent structure accepted by the FTA provided for the originator to sell its receivables to a foreign SPV which would fund the purchase through an issue of ABS. Alternatively, it seems clear that an originator can sell its receivables to a commercial paper conduit or similar financing vehicle.

Recent market trends

The years 2006 and 2007 were particularly active for both origination and securitisation. New asset classes (eg, hospitals, car rental agreements, leasing and credit cards) have been considered by investors and financing banks. Some large financing transactions have been structured in the private hospital and car leasing sectors as 'opco/propco' transactions, in which one company (the propco) owns, for example, real estate, which as landlord it leases to an operating company (the opco).

Opco/propco structures offer certain advantages because the assets backing the loan and the securities are ring fenced and the business risk of the borrower's group is largely isolated from the propco.

Swiss law offers the features needed to properly set up an opco/propco structure and to ring fence the assets backing the loan and the CMBS. In addition, the income stream on the real estate portfolio may be structured in a manner so that the secured loan will be securitisation friendly. The challenge of such transactions, however, is developing a tax-efficient transaction structure. The purchase price for the assets to be segregated from the business will have a significant impact on capital gain taxes and the propco's interest costs must be recognised as tax deductible. There is an inherent conflict between ring-fencing assets and tax efficiency - the most tax-efficient structure might not be the most robust structure for the segregation of the assets and a case-by-case analysis is

Table 2: Tax issues

Is stamp duty or any other tax imposed on the transfer of receivables?	No, provided that a tax true sale for tax purposes is recognised. If the receivables arise under a loan secured by Swiss real estate, then a source tax on the interest payments will apply.
Is value added tax imposed on the transfer of receivables?	No.
Is value added tax imposed on the fee paid to the servicer of the receivables or ABS assets?	Yes, if the servicing is provided by a Swiss servicer to a Swiss SPV. No, if servicing is provided by a non-Swiss servicer to a non-Swiss SPV. Case-by-case review is applied if the servicing is provided by a Swiss servicer to a non-Swiss SPV.
Is withholding tax imposed on payments to an offshore recipient which are not interest payments?	No.
Is withholding tax imposed on payments to an offshore recipient which are interest payments?	Yes, subject to some detailed exceptions.
Is a purchaser of receivables or other ABS assets from a Swiss originator subject to taxation in Switzerland?	No, if the purchaser does not have permanent establishment in Switzerland.

required. If well planned and carefully structured, it should be possible to get to the preferred opco/propco structure by using tax-neutral restructuring measures recognised under Swiss law (eg, split-ups, spin-offs, hive-downs or tax-neutral transfers of assets), and to get binding tax rulings for the restructuring before its implementation.

It is important for a lender to calculate properly the deferred corporate income or capital gain taxes triggered by the transaction (roughly 20 per cent on the difference between the tax book value and the fair market value of the real estate portfolio), and factor these into the terms of the loan. In particular, lenders need to bear in mind that such deferred taxes, if they become due, are – at least in some of the 26 Swiss cantons – secured by legal liens on behalf of the tax authorities ranking ahead of the first ranking security provided to the lenders.

Security in Swiss real estate lending

In Switzerland, security for the repayment of a loan used for the purchase of real estate is generally created by the obligor executing a *Schuldbrief* and delivering it to the lender. The *Schuldbrief* is independent evidence of the obligor's debt and is usually recorded in a public land register as an encumbrance on the relevant property. The *Schuldbrief* is normally issued to the obligor in bearer form and the security interest is created by the obligor delivering the *Schuldbrief* to the lender pursuant to a security assignment. If the *Schuldbrief* has been issued in registered form, it also must be endorsed by the obligor in favour of the lender. The security assignment gives the lender the power to seek what is tantamount to the sale of the property in foreclosure proceedings if the obligor defaults on its obligations.

The lender/originator in a commercial or residential real estate securitisation also will make a security assignment to the purchaser of each *Schuldbrief* which was delivered pursuant to a security assignment made by an obligor to the lender/originator when the relevant loans were originated. Careful structuring is needed to ensure that the purchaser has taken delivery of the *Schuldbriefe* securing real estate loans in an asset-backed securities transaction and that any servicer may take possession of the *Schuldbriefe* when needed for debt enforcement purposes.

Security agent structure

In Swiss securitisation transactions, a security agent is used instead of a security trustee and a parallel debt structure.

Typically, the security agent does not acquire legal rights in relation to the security interest; nor does it enforce them in its own name. This normally also ensures compliance with regulatory requirements that some mortgage bank lenders may have (eg, German *Pfandbriefbanks*). It acts only on behalf of the lenders which have appointed it as their representative. The enforcement of a security interest by the security agent requires evidence of its appointment and proof that the lenders are entitled to begin enforcement proceedings under the terms of the security assignment made by the relevant borrower in favour of the lenders. The appointment of the security agent generally does not require the amendment of the security documents or any public filings or registrations.

There is also no need to register the transfer of the real estate loans in a public register, but the new obligee of the loans may be registered in the relevant cantonal creditor register. This is not recommended in some Swiss cantons because registration may trigger additional taxes. In any case, registration does not affect the rights of the creditor.

Benefits of the Merger Law for real estate portfolio transactions

The Federal Law concerning Merger, Divestiture, Restructuring and Asset Transfer (October 3 2003) permits a corporation or any business registered in a cantonal Commercial Register to transfer all or a part of its assets and liabilities to another entity in a single transaction known as a 'universal succession'. For reasons outlined below, this feature of the law provides a potentially more cost-efficient way to transfer title in real estate portfolio transactions.

Form and content of transfer agreement

A transfer of assets under the Merger Law must be made in writing and, if the assets to be transferred are one or more real properties, the provisions of the agreement relating to the following areas must be set forth in a publicly recorded certificate:

- the identity of the parties to the agreement;
- the description of the real estate;
- the consideration paid for the real estate; and
- any other provisions which refer to the real estate or which are relevant to the transfer of the properties.

Although the parties are required to disclose only the above-listed parts of the transfer agreement in the recorded certificate, they should consider whether it is preferable to include the entire agreement in the recorded certificate and so avoid any issue about whether all provisions required to be included in the recorded certificate were included.

Inventory

A transfer agreement relying on the Merger Law also must include an inventory of the assets and liabilities to be transferred. If real estate is to be transferred, an exact description of each property from the relevant land register is required. Only assets which have an effect on tangible assets reported on the balance sheet are to be included in the inventory. As a result, intangible items, such as goodwill, will be excluded. This may become important because the inventory, including all assets, needs to reveal a net surplus.

Prerequisites for the conclusion of the transfer agreement

The shareholders or partners of the originator need not pass a resolution approving a transfer of the assets pursuant to the Merger Law, but they must be informed about the transfer, either at a general meeting or in the annex to the transferor's annual report. The transfer agreement must be executed by the highest management bodies of each of the entities involved - the board of directors in the case of a corporation. In addition, the same management body of the transferring company must apply for registration of the transfer in the relevant Commercial Register.

Notarisation requirements

Before the enactment of the Merger Law, any agreement transferring real property had to be notarised by a notary where the real property was located. If more than one real property was to be transferred, a separate publicly recorded certificate, subject to a separate notary fee for each certificate, was required. If real property is transferred pursuant to the Merger Law, then a single publicly recorded certificate notarised by the notary at the place where the transferring company is domiciled is sufficient. This provision of the Merger Law is especially helpful in transactions involving a number of real properties.

Effective date of the asset transfer

A transfer of assets under the Merger Law becomes legally effective when the transfer is recorded in the relevant Commercial Register. All assets shown in the inventory included in the transfer agreement are transferred automatically to the acquirer without any further action by the parties. The application to record the transfer in the relevant Commercial Register must be accompanied by the transfer agreement and the resolution of the board of directors (or other relevant body) of the transferor approving the transfer (unless the transfer agreement was signed by all members of the board of directors or other relevant body).

If the ownership of real estate is not transferred under the Merger Law, the transfer becomes legally effective between the parties when the new ownership is recorded in the relevant land register. Even when ownership is transferred under the Merger Law, it is important to record the transfer in the land register promptly to exclude ownership of the property by a good-faith purchaser without knowledge of the transfer made pursuant to the Merger Law.

Tax

The following tax considerations need to be addressed in a typical CMBS transaction involving Swiss loans. Advance tax rulings should be obtained from the relevant tax authorities to ensure that no adverse tax consequences arise in connection with the transaction.

Federal withholding tax

The Federal Law concerning Withholding Tax (October 13 1965) imposes a 35 per cent withholding tax on distributions in respect of so-called 'moveable capital assets', which include interest paid on accounts with Swiss banks and savings institutions and dividends paid on shares or interest paid on bonds issued by a Swiss issuer (an issuer which either is incorporated in Switzerland or effectively managed and controlled in Switzerland). The FTA stated in a 1999 interpretive notice concerning bonds that bonds are debt instruments issued by a Swiss issuer in an aggregate principal amount in excess of Sfr500,000, which have identical terms and are issued to more than 10 holders of the debt, or which have differing terms and are issued to more than 20 holders of the debt. Accordingly, a Swiss issuer of ABS would, in most transactions, be required to withhold taxes, and therefore ABS are normally not issued by special purpose entities established in Switzerland.

If a transaction can be completed with fewer than 10 holders of debt instruments issued on identical terms or 20 holders of debt instruments issued on differing terms, then the securities need to be issued subject to transfer restrictions which ensure that the limitations on the number of debt holders are not breached. If the limitations on the number of debt holders must be exceeded, there is doubt as to whether an agreement by the issuer to gross-up interest payments to offset the effect of the withholding tax always would be enforceable. The FTA has said, however, that gross-up provisions are permissible if:

- at the time the agreement is made, the parties believe in good faith that the interest payments are not subject to withholding taxes;
- the borrower has agreed in both the provision governing interest payments and the tax gross-up clause that it will pay a minimum rate of interest, subject to adjustment if withholding taxes are imposed;
- any withholding taxes imposed are calculated and paid on the grossed-up amount of the interest payment; and

- the borrower agrees to provide the lender with any documentation needed to seek a refund of withholding taxes.

It should be noted that the FTA's position is not binding on a court which must determine whether a gross-up provision is valid and enforceable.

Withholding tax on loans secured by real estate

Interest payments made to a lender which is not resident in Switzerland for tax purposes on a loan secured by a security interest in Swiss real property are subject to federal and cantonal withholding taxes. These withholding taxes generally are in a range from 17 per cent to 33 per cent, depending on the canton where the real property is located. If the lender is eligible for benefits under a treaty for the avoidance of double taxation with respect to taxes on income, then this withholding tax may be reduced to the allowed rate under the treaty or even eliminated. Interest payment gross-up provisions to offset the effect of the withholding tax on interest rate payments on loans secured by Swiss real estate are valid and enforceable.

Cantonal capital gains and transfer taxes and stamp duty

In some cantons, gains realised by a seller on the transfer of real property held as a business asset are subject to a tax on capital gains. This capital gains tax is generally imposed on the seller, but if the tax is not paid, the relevant taxing authorities may cause a lien to be placed on the property. This tax lien may have priority over other security interests encumbering the property. Accordingly, the agreement governing the sale of the real estate should provide for a portion of the purchase price to be held in escrow for the payment of the capital gains tax. Alternatively, the seller should provide a first-demand guarantee for the payment of the tax.

In addition, cantonal taxes, registration fees or other duties may be imposed in respect of the transfer of real property or the creation of a security interest in real property. Local law may provide that such taxes, fees and duties are paid by the seller or the buyer or the transferor or transferee of a security interest, or that they are allocated between them.

Some cantons (ie, the cantons of Basel City, Geneva, Valais, Vaud and Ticino) levy a separate stamp duty on certain documents, such as:

- written acknowledgements of a debt;
- certain contracts;
- the issue or transfer of certain security instruments; or
- the filing of certain documents or instruments with a local court or public body.

Taxes based on the use of 'hidden equity'

The FTA has issued rules on the use of so-called 'hidden equity' that aim to deny expense treatment for interest payments on loans made to the company by related parties or from third parties that lend to the company on a secured basis or with the benefit of a guarantee from parties related to the company. These rules, also known as 'thin capitalisation rules', permit a finance company with related-party debt financing to have debt equal to six-sevenths of its assets (valued at market value with specified reductions applicable to various types of illiquid assets). If this requirement is not met, the use of hidden equity capital will be presumed and interest payments made to related parties attributable to the hidden equity portion of the debt will be included in the taxable profits of the company. In addition, the capital tax payable on equity capital will be imposed on the amount of the hidden equity capital.

Conclusion

After tremendous growth in the Swiss securitisation market, mainly through CMBS transactions in 2005, 2006 and the first half of 2007, it remains to be seen when the Swiss securitisation market will regain momentum once the international financial markets have recovered from the current crisis. As the underlying fundamentals of the Swiss economy, and the Swiss real estate market in particular, have not been adversely affected by the current crisis so far, market participants tend to be optimistic about the medium-term prospects of the Swiss securitisation and CMBS market. More opco/propco transactions are expected, as well as a general trend towards public-private partnership transactions in the future.