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Real estate financing through SPV-issued capital market instruments

Investors and real estate developers are considering new ways of financing real estate transactions. Most recently, we have seen a rise in private placements of bonds and similar capital market instruments by so called special purpose vehicles (SPVs) with the aim to raise funds for portfolio real estate assets. This edition of Advestra Insights focuses on structuring options and lessons learned when issuing such instruments in the real estate realm.

1 INTRODUCTION

The coronavirus crisis has not slowed demand for residential property. Quite the opposite, prices for condominiums and single-family dwellings have risen almost continuously since 2002. Initially, the reasons behind the increase in demand for residential properties and the rise in prices were low price levels and strong economic growth. Over the last few years, historically low mortgage rates have been the main driver.[1] However, demand for office space remains subdued, as companies are reluctant to rent new premises and are reviewing the extent to which they can make long-term savings on office space through home working.

Overall, the consequences of COVID-19 will prove challenging for the real estate market, as the pandemic is triggering structural changes particularly in demand. As markets are changing, investors and real estate developers are considering new ways of financing real estate transactions. Most recently, we have seen a rise in private placements of bonds and similar capital market instruments by so called special purpose vehicles (SPVs) with the aim to raise funds for portfolio real estate assets. The following Advestra Insights provides an overview of structuring, regulatory and tax implications that need to be considered when issuing capital market instruments in the real estate realm and some lessons learned from recent transactions.

2 STRUCTURING CONSIDERATIONS OF THE SPV AND THE BONDS

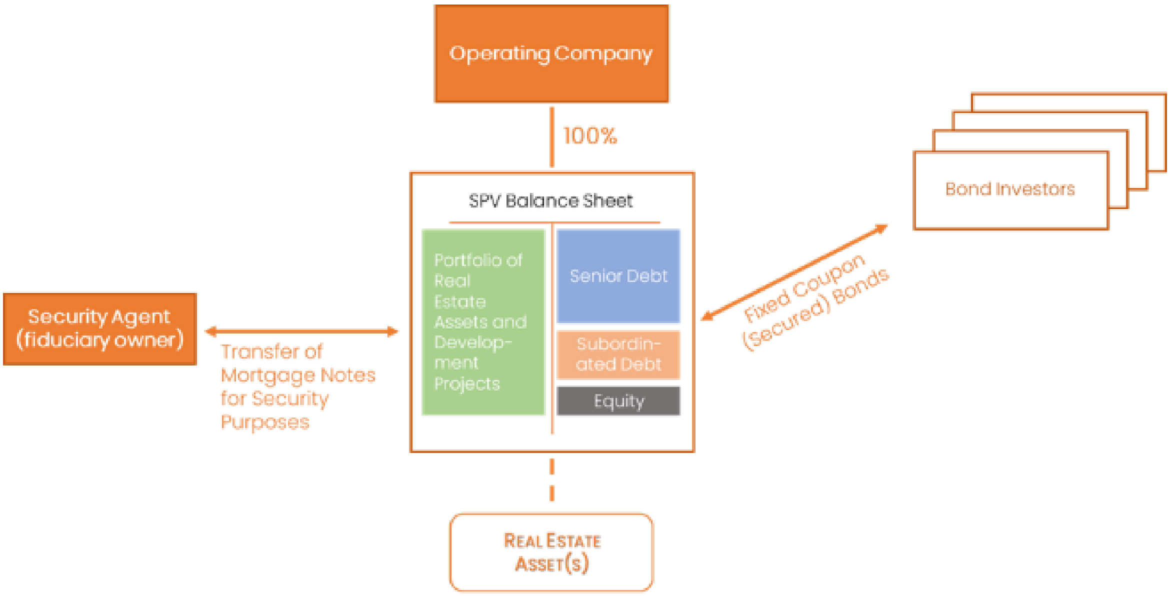
SPV structures are used to either refinance a pool of existing real estate assets or to fund

[1] cf. Credit Suisse 2021 Real Estate Study and Real Estate Monitor.

new development projects. Typically, a portfolio of real estate assets is financed with equity and debt, as full debt financing – investing in real estate without equity – has proven difficult in Switzerland. In such structures, the SPV is capitalized with equity, provided by the sponsor. The amount of equity depends particularly on the real estate portfolio, but appears to vary between 10%-20% of the overall financing needs. The debt financing component usually follows a two-tier structure: (i) a senior debt layer and (ii) a subordinated (mezzanine) debt layer. The senior debt layer typically benefits from a first lien on the portfolio real estate assets and amounts to roughly 50-65% of the overall financing needs. Such senior debt may be financed through bank debt and, increasingly, private debt placed with institutional investors. The subordinated debt layer, in contrast, only benefits from a second lien on the portfolio real estate assets, sometimes backed up with further forms of collateral or protection such as a pledge on the SPV shares, and an assignment of lease receivables and insurance policies or similar forms of security. The subordinated debt is often placed with dedicated mezzanine real estate debt funds or similar investors, who have the appropriate risk appetite for such investments.

With respect to the debt structuring, however, we have seen a trend most recently from classic (senior and/or subordinated) mortgage loans provided by lenders towards the issuance of capital market instruments by an SPV to investors. Such capital market instruments are often structured as bonds (*Anleihen*) and may cover (i) either the senior debt layer or subordinated debt layer only or (ii) both layers (resulting in a one tier debt structure rather than a two-tier structure). The bonds are frequently secured with a first (or second) lien on the underlying portfolio real estate assets.

Graphically, such structure may be summarized as follows:



The **nominal amount, coupon and tenor** of the bonds may vary depending on the underlying portfolio of real estate assets. The interest coupon depends on whether the bonds cover the senior debt layer and/or the subordinated debt layer. In case of the former, the coupon tends to be very low (e.g. 200bps – 300bps over swap), in line with historically low mortgage rates at present; in case of the latter, yields in the CHF real estate market tend to be around 5%-6% *p.a.* or even higher.

The Swiss market standard for the **denomination of bonds** is CHF 5,000.

However, with respect to real estate bonds, denominations are typically higher, starting from CHF 100,000 up to a few millions depending on the overall nominal amount of the bonds. The denomination may also be driven by regulatory and/or tax considerations which will be discussed later in this Insights. To increase flexibility, the SPV often reserves the right to reopen and increase the nominal amount of the bonds at any time and without prior consultation of or permission of the bond holders through the issue of further bonds which are fungible with the bonds that were already issued.

From an investor perspective, financial instruments having an **ISIN and Valor identifier** are preferred as it facilitates the performance reporting together with other asset classes. Such efficient transaction/asset reporting is particularly relevant for asset managers being required to regularly report on the performance of the assets under management. In Switzerland, SIX as the official securities numbering agency, is responsible for the issuance of Valor and ISIN identifiers which may be reserved in advance. Furthermore, in order to deposit the bonds in a securities account of a deposit bank, they should constitute intermediated securities (*Bucheffekten*) which is usually done by issuing the bonds as uncertificated securities (*Wertrechte*) and then entering them into the main register (*Hauptregister*) of SIX SIS Ltd or another recognized intermediary in Switzerland.

From a legal perspective, no **paying agent** handling the payments under the bonds on behalf of the SPV is required. If no paying agent is appointed, the SPV is responsible for effecting the interest payments and the repayment of the nominal amount at the end of the tenor. In practice, however, sponsors tend to prefer to designate a paying agent handling all payments relating to the bonds.

Similar considerations apply with respect to the **appointment of a bond holder representative**. In private placement structures, often no bond holder representative is designated in the terms and conditions of the bonds but bond holders holding at least 5% of the outstanding nominal amount of the bonds retain the right to request a creditors' meeting (in accordance with article 1157 et seq. CO) and, at such meeting, may elect a bond holder representative which is particularly relevant in an event of default.

The issued bonds may either be (i) underwritten by an underwriting bank or securities firm who sells them on to prospective investors or (ii) placed with e.g. an asset manager allocating the bonds to its own end clients or directly with certain end investors. In line with market standard, settlement of the bonds and payment of the purchase price is done concurrently (*Delivery versus Payment, DvP*).

3 THE COLLATERAL FOR THE BONDS

3.1 Structuring of the Collateral

Typically, the bonds are secured with a first (or second) lien on the portfolio real estate assets. A security interest in the assets (security *in rem*) is usually preferable to e.g. a guarantee provided by the sponsor (security *in personam*) as it bears the advantage that its value is determinable and value preserving whereas (corporate) guarantees require some kind of ring-fencing to avoid a drain on substance. If the bonds only cover the subordinated (mezzanine) debt layer, a second ranked lien on the portfolio assets tends to be the strongest available collateral for the bond holders.

The security interest generally takes the form of a mortgage note (*Schuldbrief*). Mortgage notes represent a personal claim against the issuer that is secured by a mortgage/security interest in real estate. The secured amount under the mortgage note should at least be equal to the nominal amount of the bonds, but may also be higher to cover unpaid interest.

For security purposes, the mortgage notes are usually transferred to a security agent structured as a *true sale*. The SPV and the security agent enter into a written security transfer agreement to transfer legal title of the mortgage note to the security agent, either by transfer of possession in the case of paper mortgage notes or registration of the transfer in the land register in the case of paperless (registered) notes. Such security transfer is well suited for securing bonds as it is of a non-accessory nature and also the preferred security structure of Swiss banks for their mortgage business. The terms and conditions of the bonds then determine certain events of default upon occurrence of which the security agent may enforce the collateral (see also chapter 3.2 below).

Instead of a security transfer, it is also possible to pledge mortgage notes. However, practitioners usually prefer a security transfer of legal title to a security agent over the creation of a pledge. The advantage of the former is the transfer of full legal title of the mortgage notes and, hence, the notes not becoming part of the debtor's (i.e. the SPV's) bankruptcy estate.

3.2 Enforcement of the Collateral

As a general rule, once the payment obligations become due and payable by the debtor, the mortgagee may enforce the claim incorporated in the mortgage note by means of a formal enforcement in the property (*Betreibung auf Grundpfandverwertung*). The debt enforcement office either publicly auctions the property after receipt of the request for realisation or sells the property privately (*Freihandverkauf*). The latter is, however, only permissible if (i) all parties concerned agree, (ii) the appraisal price has been achieved and (iii) an encumbrance clearing (*Lastenbereinigung*) has been carried out.

Apart from a formal enforcement in the property as outlined above, security agreements often provide for the option of a private sale (including a purchase by the mortgagee itself (*Selbsteintritt*)) or the public auction/offering of the mortgage notes. The noteholder is then free to contact only few potential buyers and individually agree on the purchase price, or even to structure the sale as a private auction with only a few bidders. The purchase of the mortgage note does not confer, however, the full ownership of the property and the new noteholder must take over the step of enforcing the mortgage incorporated in the mortgage note through formal enforcement proceedings. This is where a pledge of the shares in the SPV can come useful as it allows the creditors to take full and direct ownership of the issuer and thus, indirectly, of the property, which can then be sold on privately.

4 ACQUISITION OF SWISS REAL ESTATE BY PERSONS ABROAD (LEX KOLLER)

The acquisition of real property in Switzerland by persons abroad is in principle subject to authorization. Such authorization is required if the acquiring party qualifies as *person abroad*, if the real property in question is *not used for purposes exempted* from authorization (such as e.g. permanent business establishments)[2] and if the transaction qualifies as *acquisition* within the meaning of the applicable law.

The term *acquisition* is construed in a very broad and economic manner to every kind of control over or interest in real property, including under certain circumstances through debt instruments. Hence, it needs to be ensured that acquiring a bond is not deemed to be an *acquisition* which could result in an authorization requirement for the bond holder. The term *acquisition* includes – *inter alia* – the acquisition of any other right that grants to its holder a similar position to the one of an owner. As such right qualify for

[2] This includes e.g. manufacturing premises, warehouse facilities, offices, shopping centers, retail premises, hotels, restaurants, workshops, etc.

instance the financing (or guarantee of such financing) of the purchase or development of a real property if unusual clauses, the lending proportion or the economic situation of the borrower lead to a particular dependence of the borrower on the lender. Such dependence is presumed if the usual lending limits applied by Swiss banks are exceeded. This is typically the case if the loan-to-value ratio exceeds 80% and for most mezzanine and hybrid layers. In such contexts, foreign control is presumed if foreign investors purchase bonds that account for more than half of the difference between the assets of the SPV and its debts to persons not subject to authorization.

With respect to the security structure, holding the collateral does, *per se*, not provide the security holder (i.e. the security agent) a similar position to the one of an owner. However, issues may arise if a foreign security agent has (i) very broad control rights or (ii) the right to purchase the mortgage notes itself (*Selbsteintritt*) which is generally the case to ensure an effective enforcement of the underlying mortgage.

Hence, the issuance of bonds with the aim of financing residential property (including commercial property that could be used to build residential property) in Switzerland needs to be carefully structured to prevent any foreign investors from participating in the offering or to ensure that they do not amount to a sale of real estate from a Lex Koller perspective.

5 REGULATORY CONSIDERATIONS

5.1 Overview

The issuance of debt instruments raises a number of regulatory issues that need to be carefully addressed to avoid being subject to a prohibitive regulatory burden or engaging in a regulated business without an appropriate authorisation or approval.

5.2 Avoidance of Qualification as Collective Investment Schemes

The first area of concern for any structure involving an SPV is compliance with the Federal Act on Collective Investment Schemes of 23 June 2006 (CISA). Pursuant to the CISA, collective investment schemes are defined as (i) assets raised from investors for the purpose of collective investments, and (ii) which are managed by third parties for the account of such investors. The investment requirements of the investors are met on an equal basis.[3]

The SPV will typically meet the first prong of the definition as they pool financial means from investors with the purpose of generating income and/or capital gains. Hence, the characterisation of the SPV as collective investment scheme hinges on the degree of entrepreneurial activity and self-management and the SPV might be considered as collective investment scheme in the meaning of CISA. However, an SPV may avail itself of the exception in article 2 (3) CISA, which exempts Swiss joint-stock corporations that only have (i) qualified investors under article 10 (3), (3^{bis}) and (3^{ter}) CISA and (ii) registered shares from the application of the CISA.

While the CISA considers first and foremost (equity) investments in collective investment schemes, rather than debt granted to a collective investment schemes, it may be advisable to limit investments in bonds to qualified investors in the meaning of CISA, in particular, in connection with mezzanine instruments which due to their subordinated nature and other features may be recharacterised as equity investments.[4]

[3] This definition also comprises foreign fund structures, such as assets that are accumulated on the basis of a fund contract or another agreement with similar effect for the purpose of collective investment and are managed by a fund management company with its registered office and main administrative office abroad.

[4] Issuing bonds to qualified investors only also avoids any potential risk if the bonds are not

Furthermore, to ensure ongoing compliance, the transfer of bonds is restricted by transfer restrictions embedded in the terms and conditions of the bonds. By contrast, we have not, as of yet, seen a wide use of registered bonds in practice.

5.3 Anti-Money Laundering Considerations

Even if the SPV is exempted from CISA and hence not a regulated investment scheme, in its revised FINMA Circular 2011/01 regarding the activity of financial intermediation according to the Federal Act on Combating Money Laundering and Terrorist Financing in the Financial Sector of 10 October 1997 (AMLA), the Swiss Financial Market Supervisory Authority FINMA expresses the view that investment companies, which do not fall within the scope of CISA pursuant to article 2 (3) CISA are still encompassed by article 2 (3) AMLA. Hence, even if the SPV is structured as an exempt investment company under article 2 (3) CISA (see chapter 5.1 above), it qualifies as financial intermediary in the meaning of AMLA and, thus, is subject to Swiss AML rules. Swiss AML rules define and establish certain duties for financial intermediaries (e.g. duty to become a member of a self-regulatory organization (SRO), duty to identify customers and beneficial owners, notification duties). Consequently, the SPV may need to join an SRO and comply with the requirements under AMLA. As SPVs rarely employ their own staff, it is fairly common to outsource the AML functions to third parties.

Depending on the circumstances, the SPV might not directly invest in portfolio real estate assets, but provide loans (to another SPV) which are used to finance the assets. Under Swiss AML rules, the lending of money on a professional basis to a borrower against the borrower's obligation to repay the nominal amount of the loan and to pay interest on such loan triggers Swiss AML duties. The provision covers mortgage loans, overdrafts, lombard loans, long-term loans including participatory loans or subordinated loans, irrespective of whether such loans are secured by any type of security or not. The criteria "on a professional basis" is met if gross proceeds of more than CHF 250,000 are generated in a calendar year and a credit volume of more than CHF 5 million is outstanding at any given time, regardless of the number of counterparties. Hence, financing activity in connection with the financing of real estate assets qualifies, subject to the thresholds mentioned above, as financial intermediation in the meaning of AMLA.

This requirement incidentally also applies to investors extending loans to the SPV, whereas investing in bonds (as a financial instrument) is not deemed to be a financial intermediary activity and, hence, does not trigger any AML duties for investors.

5.4 Prospectus Requirements and the Problem of Deposit Taking

In case the bonds are publicly offered in Switzerland, the SPV would be required to publish a prospectus in line with article 35 of the Federal Act on Financial Services of 15 June 2018 (FinSA). To avoid the regulatory burden of complying with these requirements, real estate bonds are typically placed privately in which case they may be offered without publishing a prospectus or rely on one of the exemptions from the requirement to publish a prospectus e.g. (i) by offering them to investors meeting the definition of professional clients within the meaning of FinSA, (ii) by limiting the offering to fewer than 500 investors or (iii) by offering the bonds in denominations of at least CHF

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structured as true fixed income products but rather linked to the performance of certain assets (e.g. by way of collateralization and/or subordination). This is particularly relevant for mezzanine bonds due to their more hybrid/equity character compared to senior bonds.

100,000 or exclusively to investors acquiring bonds of a value exceeding CHF 100,000.[5]

While FinSA would typically allow non-regulated issuers such as SPVs to privately place bonds to more than 20 offerees, such private placement might be considered deposit taking under the Federal Act on Banks and Saving Banks of 8 November 1934 triggering the requirement to obtain a banking license. To address this problem, article 5 (3)(b) of the Banking Ordinance exempts bonds from the definition of deposits provided that certain minimum information on the issuer and the securities at the time of offering the bonds is disclosed. Hence, to avoid any banking license requirements, certain minimum information about the SPV and the bonds needs to be included in the summary terms of the bonds in the form of an extended term sheet.

6 FURTHER BOOST BY NEW TAX LAWS?

As of now, interest on debt instruments issued by Swiss companies is subject to a withholding tax of 35% if such instruments are issued to more than 10 lenders, including through participations, which are not banks (10 Non-Bank Rule) or if the issuer has debt relationships with different conditions with more than 20 lenders which are not banks (20 Non-Bank Rule). Such rules not only significantly complicate the placement of Swiss bonds on the international capital market, but also require a careful structuring around strict transfer restrictions in the terms and conditions of the bonds.

However, on 15 April 2021 the Swiss Federal Council announced its intention to amend the Swiss Withholding Tax Act which will make it possible to issue bonds from Switzerland without withholding tax consequences making the 10/20 non-bank rules superfluous. The new rules would apply for new issues, but also to bonds already issued with reference to future interest due dates. The proposed amendments may result in a significant reduction of refinancing costs for smaller companies (including in the real estate sector) and may boost capital formation through issuing bonds.

7 CONCLUSION AND OUTLOOK

As outlined herein, real estate financing through bonds issued by SPVs has the potential to become a significant way of capital formation in the real estate realm to refinance a pool of existing real estate assets or to fund new development projects. This may hold even more upon abolition of the Swiss withholding tax on bonds issued by Swiss companies. Contrary to popular opinion, the implementation and running costs of such SPV structures tend to be in line with costs of classic real estate financings and, thanks to its potential of duplication, may be significantly lower for repeated transactions.

However, the specific structure, including the appropriate security package, should be carefully assessed in order to find structuring solutions that accommodate both the interest of real estate developers and those of investors.

[5] The listing of the bonds at a trading venue might also trigger a prospectus requirement under FinSA (which is, however, usually not contemplated for such private bonds structures).

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