

Newsletter

Talking about COSI® and bazookas

Dear readers,

In fall 2014, COSI celebrated its five-year anniversary. The collateralization mechanism was launched in autumn 2009 in a market environment dominated by the aftermath of the Lehman Brothers bankruptcy. In its first three years, COSI grew impressively, before reaching its initial maturity phase in 2013 with over 2,650 products and more than CHF 3 billion deposited as collateral. Since then, the assurances from the ECB to support the bond market with unlimited funds have borne fruit: investor confidence has returned, which in turn has somewhat calmed and stabilized the previously shaken markets. And justifiably so: financial institutions, in particular, now have a more solid financial base thanks to the new, stricter capital adequacy and liquidity requirements. Credit and default risks, which are reflected in yield premiums, have continually fallen, as has investors' aversion to risk. Given the market's current perception of risk, it is therefore logical that COSI's relevance has waned a little.

We therefore need to ask the question: given the prevailing market environment, is COSI a thing of the past? You can find our answer to this in our main article on page 3.

It's already clear now that there are still product segments that continue to post steady growth, for example, COSI certificates with reference bonds, where the issuer default risk is minimized using COSI and is replaced by the credit risk of the reference bond. We have also seen a growth in COSIs tradeable on the Frankfurt Börse and a rising demand from Austria.

The interview in this edition is therefore dedicated to our neighbors to the east. Michael Witsch and Andreas Gass, managing directors at the Austrian distribution manager gawi GmbH, provide a deeper insight into the particu-

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Interview with Michael Witsch and Andreas Gass, gawi GmbH

"Certificates are again in fashion and could play an important part when it comes to advisory services going forward!"

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lar characteristics of the Austrian market on page 8.

Finally, on page 5, we take the opportunity to present TCM by SIX®, a supplementary collateral solution from SIX aimed at the OTC market, and to discuss how this differs from COSI.

Your SIX Structured Products team hopes you enjoy reading our informative newsletter.

Draghi's bazooka – is COSI a thing of the past?

At the height of the Euro debt crisis in 2012, Mario Draghi's much-cited "Bazooka"⁽¹⁾ returned credit spreads in those countries suffering difficulties to manageable levels and brought stability and security to European markets. As a result, the ECB's low interest rate policy helped equities regain popularity and soon thereafter, leading indicators reached record highs not seen for many years. Meanwhile volatility reached a new low and the inflation forecast for 2015 is not expected to emerge in the foreseeable future. Investors could therefore think that they have entered a golden period of controllable risk and stability.

But everything that glitters is not gold: individual countries are only reducing their debts at a slow pace, and this process is accompanied by low or negative growth. While we are aware of the risks associated with this, we have got used to them over time and our familiarity with them has given us a false sense of security. Our individual perceptions of risk could therefore have become distorted and it could well be that we are allowing ourselves to be blinded by the good news

Fear and uncertainty dominate individual risk perception

Research in this area has identified two factors as being key with regard to individual risk perception: fear and uncertainty. Fear is linked to other factors, such as a lack of control, worries over the potential impact of events (including the potential for catastrophe), and the increase of risk over time, while uncertainty is a result of not being able to monitor events, a new development on the market, or a lack of expert knowledge, for example.

As we have long known, fear is a poor basis on which to make decisions and often leads to extreme, unconsidered reactions. By contrast, a lack of uncertainty or a sense of security can lead to investors underestimating risk. As investors, we must occasionally ask ourselves whether we are paying sufficient attention to the investment risks relevant in the prevailing market (for example, credit or default risk) or whether there

is a risk that we are systematically underestimating. Here we have some food for thought.

According to an online survey carried out by the German Derivatives Association in summer 2014, three out of four investors take into account an issuer's credit rating when buying a structured product. Measuring and evaluating issuer risk therefore plays an important role in this respect.

Metrics for measuring issuer risk

If we look at an issuer's credit rating and credit premium - the so-called credit spread - we can ascertain how likely market participants think it is for this issuer to default on its payments.

Credit ratings are issued by independent specialist agencies such as Moody's, Standard & Poor's or Fitch. The rating is based on an evaluation of qualitative information (e.g. the political risk in the company's home country) as well as quantitative figures (e.g. equity ratio). The borrower's default risk is then indicated by means of a credit rating ranging from AAA (triple A) for the best borrower quality to D for payment defaults.

Asset class	Number of COSIs
Bonds	41
Commodities	27
Equities	1,044
Forex	6
Money market/swaps	182
Precious metals	26
Real estate	1
Various asset classes	94
Total	1,421

Source: SIX Structured Products, November 2014

(1) The press coined the phrase "bazooka" to refer to effective measures taken by central banks to tackle the financial and debt crisis following 2009. Specifically, this refers to purchases by the central bank of government and bank bonds on the secondary market in order to increase demand and lower yields. In this respect, the central bank assumes the role of "lender of last resort", where in the past even the announcement of a potential intervention by the central bank was able to boost investor confidence and calm the markets. For example, the announcement by Mario Draghi, President of the ECB, that the central bank would, if necessary, intervene on the bond market with "unlimited financial resources" saw yields on Spanish government bonds fall from 7.5 % in July 2012 to 5.6% within just two months.

Ratings between "triple A" and "triple B" are considered "investment grade", with the probability of default (cumulative, over ten years) for AAA bonds amounting to 0.5% and 4.6% for BBB bonds. Borrowers usually have to pay for these ratings, meaning that they are not available for all issuers.

Credit spreads

A credit spread is a risk premium, the size of which depends on the issuer's default risk. The premium corresponds to the expected difference in income generated by a risky bond and a risk-free investment that otherwise has an identical structure (usually a government bond). The higher the credit spread, the higher the market believes the issuer's default risk to be.

Both of these risk figures are easy to understand and are readily available in most cases. This means we know how they have changed over the last two years: the credit ratings of countries and companies have continually improved and risk premiums have fallen accordingly. This saw Ireland being given back its A/"upper medium grade" rating by S&P and Fitch last summer, while the credit spreads of structured product issuers that operate in Switzerland have again been well below 100 basis points for months.

Shortcomings of these metrics

Both figures have their shortcomings, however. Credit ratings, for example, are calculated on the basis of models and parameters that the agencies themselves do not publish in any great detail. Furthermore, rating agencies are potentially open to accusations that they risk their independence due to the (paying) relationship they have with the issuers they are evaluating. By contrast, credit spreads are not calculated by independent agencies, but are instead determined based on the supply and demand in the market, meaning they are more up to date and neutral. We have known at least since the bursting of the US real estate bubble in 2007 that market mechanisms can be subject to distortions and that market prices – also in the form of risk premiums – may inherently differ significantly from prices that are economically justified.

While in the case of a classical market failure it is the job of the regulator to intervene, it is more the case now that regulatory conditions are more likely the cause of potential distortions. These include the European Market Infrastructure Regulation (EMIR), which requires standardized (bilateral) OTC derivatives, es-

pecially swaps, to be cleared centrally. In the clearing process, a so-called clearing house sits between the two contracting parties and assumes the liabilities of the respective other party. The contracting partners are therefore no longer subject to the counterparty's default risk; in return for this, however, the clearing house requires that a certain amount of collateral be deposited. This means that there is a large additional demand for high-quality collateral in order for previously uncleared OTC transactions to be cleared centrally which in turn increases the demand for said collateral on the bond market. This effect is further exacerbated by the "Basel III" regulations. Under these regulations, banks must have a liquidity buffer that is sufficient for a 30-day stress scenario. This buffer may only comprise AAA and AA bonds. The resulting excess demand on the bond market drives up the prices for high-quality collateral and, independent of the actual credit rating of the issuer, drives down credit spreads.

If credit spreads are significantly influenced by the presumed imbalance in the bond market described above, their potential use as a barometer of quality will quickly diminish. This means that based on credit spreads, a borrower's default risk could potentially be evaluated as too low.


It is for readers to decide whether their perception of risk takes adequate account of this situation. However, it should be noted that whatever their decision, this is of no relevance for investors in COSI products, as these products protect investors in structured products against any loss in the value of their investment in the event of an issuer default.

Collateral-secured structured products – a SIX solution to meet every need

While the COSI collateralization mechanism with the Swiss exchange as the collateral taker is unique, it is not the only established collateralization mechanism. Long before the launch of COSI in 2009, contractual liabilities and debentures have been collateralized by means of a collateral pledge. A common method of doing so, for example, is for the issuer to deposit collateral with a company within the same group and includes the option to re-pledge this collateral. This type of collateralization offers issuers a huge degree of flexibility. In contrast to this and in the interest of investors, COSI features a harmonized standard for all issuers with respect to products that can be collateralized and their valuation as well as in relation to the pledged assets and the liquidation of collateral. Driven by the specter of the Lehman bankruptcy, COSI quickly established itself in the traditionally risk-averse Swiss market.

SIX has now tapped into the COSI success model and developed a service for the OTC market. TCM by SIX® is a collateralization solution that complements COSI. It provides investors with greater flexibility in terms of depositing collateral at the same time as an offering a greater degree of investor protection than other industry solution thanks to the mechanism provided by SIX for holding and liquidating collateral. As such, TCM by SIX is largely aimed at professional market participants, whereas COSI is also suitable for private investors.


The key differences between the two services from investors' perspective are set out below.

Service	Trading	Market making	Term	Eligible underlying instruments	Determination of collateral value
 COSI®	Exchange trading on SIX Structured Products, checking of the listing prospectus by SIX	Market Maker Obligation applies	Max. 10 years	Restricted by the SIX listing rules and the special provisions governing collateral secured instruments	Independent valuations for both the structured product and the collateral
TCM by SIX® for structured products	Structured products without exchange listing	OTC ¹ , no market making obligation	Fix term or open-end ²	In principle all securities are permitted as underlying, restrictions by SIX SIS or the issuer may apply	Products valuation is carried out by the issuer, independent valuation of the collateral

Source: SIX Structured Products, SIX Securities Services

(1) OTC = over-the-counter

(2) SIX reserves a right of termination

Service	Margin threshold ³	Eligible collateral	Concentration limits on collateral	Liquidation event and payment
 COSI [®]	Fixed margin threshold of CHF 100,000	Exhaustively regulated by the COSI [®] framework agreement	Standardized regulations and monitoring for all issuers	Standardized definition of default events, automatic maturity of affected COSI [®] products, payment in favor of the investors by SIX Swiss Exchange after 30 days
TCM by SIX [®] for structured products	Can be determined for each individual contract	Can be determined for each individual contract; all underlyings of the structured product are permitted as collateral	Can be determined for each individual contract	Can be determined for each individual contract; payment in favor of the investors by collateral agent (direct representative of investors)

Source: SIX Structured Products, SIX Securities Services

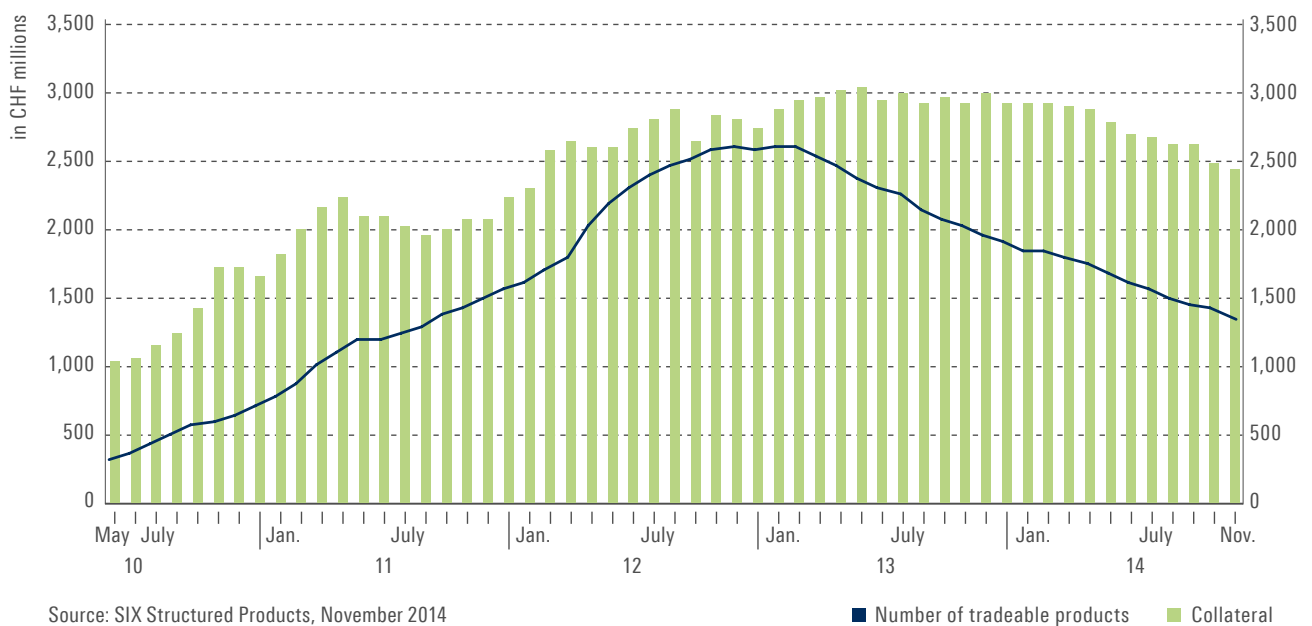
(3) Difference in value (between the structured product and the deposited securities) that requires the issuer to provide more collateral.

Post-launch development

Development since start of 2014

The number of collateral-secured instruments has been declining for some time now. This is because many products issued during the financial crisis have expired and the number of new issues has not been sufficient to offset this decline. The volume of collat-

eral deposited has also been impacted by this trend over the long run. At present, seven issuers are active in the COSI segment with an outstanding volume of CHF 2.42 billion.



COSI issuers at a glance

Collateral providers	Reference bonds	Return optimization	Participation	Capital protection	Leverage	Total
Credit Suisse	1	0	0	6	0	7
EFG International	12	70	21	80	3	186
J. Safra Sarasin	0	3	3	0	0	6
Julius Baer	0	5	30	0	0	35
Leonteq Securities	10	504	167	96	10	787
Merrill Lynch	0	0	1	0	0	1
Vontobel	301	77	21	0	0	399
Total	324	659	243	182	13	1,421

Quelle: SIX Structured Products, November 2014

Interview with Michael Witsch and Andreas Gass

Michael Witsch and Andreas Gass

Michael Witsch and Andreas Gass have over 40 years of experience in banking and insurance. Their previous employers include Volksbank, Landeshypothekenbank Steiermark, Skandia Austria and the Old Mutual Group. As managing directors of gawi GmbH, they are responsible for sales and marketing as well as expanding the business areas.



Michael Witsch and Andreas Gass, gawi GmbH

What range of services does gawi GmbH offer?

Michael Witsch: As an independent distribution manager, we offer a comprehensive industry and relationship network for domestic and international financial companies. In this respect, we provide an efficient and predictable way for companies to launch their sales in various segments and regions. Our aim is to add value for our partners with first-class product solutions and services when it comes to tapping into potential new business and client groups.

"Issuer risk and the associated risk of loss is more important than ever."

How does your collaboration with Leonteq work in general?

Andreas Gass: Leonteq provides a huge degree of flexibility, transparency and service quality, meaning it can offer exactly the type of service that financial companies require for their clients at present. The products we distribute in our network include product solutions from Leonteq, which we make available to market participants (banks, insurers, financial service providers). In doing so, we use both standardized solutions as well as a very wide range of individual options under the motto "your tailor-made investment".

Which investor requirements are covered by COSI products?

Michael Witsch: Issuer risk and the associated risk of loss is more important than ever. The current interest rate environment, in which for the first time penalty interest are all but being charged in Germany, is something new that must be taken into account. In this respect, we believe that COSI and the form in which counterparty risk is hedged add important value. The advisor and his or her clients can use flexible, capital-protected products without running the risk of a significant loss.

Are there comparable solutions in Austria or other markets?

Michael Witsch: Not to my knowledge.

How great is the market potential for collateral-secured structured products in Austria?

Andreas Gass: Together with Leonteq, we have enjoyed a very successful launch in the Austrian market over the last 16 months. While we are still at an early stage, we are convinced of the huge potential COSI can offer once it becomes better known.

Are Austrian clients prepared to pay for protection against issuer risk?

Andreas Gass: In the current market environment, protection is considered more important than returns. We

therefore believe that clients will be prepared to accept a lower performance. Nevertheless, there is still demand for high-quality and innovative investment instruments that generate positive performance.

How does the Austrian market differ from the Swiss market?

Michael Witsch: It differs mainly in the way products are distributed: in Austria, products can only be accessed and transacted via licensed financial companies or agents, meaning sales is limited, while in Switzerland a wide range of independent asset managers create a substantial demand in these products.

How flexibly can investors participate in determining the structure of the products?

Andreas Gass: As already mentioned, Leonteq's offering stands out thanks to its enormous flexibility and transparency. This means investors can themselves create an individual, tailor-made investment, from choosing the right structure to selecting the various issuers, including COSIs.

"In the current market environment, protection is considered more important than returns."

What changes do you expect to see in future?

Michael Witsch: Given the already very long period of low interest rates, investors will increasingly look around for alternative investment options. We will provide individual advice when they do and working together with Leonteq we will offer attractive solutions. Certificates are again in fashion and could play an important part when it comes to advisory services going forward!

Thank you for the interview.

Overview of top products

Category	Symbol	SSPA categorization	Underlying asset	ISIN	Total turnover in CHF
Capital protection	EFHAM	Capital protection with coupon	ABB/CS/Nestlé/Roche GS	CH0110622609	13,846,811
	EFHSX	Capital protection with coupon	n/a	CH0115890706	11,349,897
	EFGNR	Capital protection with coupon	LEON MIG Swiss equities basket	CH0106308643	6,956,325
	BCNCH	Capital protection with coupon	CS CLEU international equities basket	CH0110879472	3,183,594
	LTQAOC	Capital protection with participation	n/a	CH0215667285	3,027,116
Yield optimization	LTQCGG	Express certificate	DAX Price/EURO STOXX 50®	CH0228513807	13,457,064
	EFGERL	Express certificate	EURO STOXX 50/iShares FTSE 100/S&P500	CH0204549056	8,936,613
	EFGFUJ	Express certificate	Apple/Petroleo Brasileiro ADR	CH0208024262	6,845,731
	LTQBNW	Express certificate	EURO STOXX 50 PR Index	CH0228509151	5,411,533
	LTQAHR	Barrier reverse convertible	n/a	CH0213854364	5,380,600
Participation	LTQCTC	Tracker certificate	LEON China basket	CH0234032701	10,498,453
	EFGEFO	Tracker certificate	LEON EFG Bond Basket	CH0201061105	8,427,339
	EFGFGM	Tracker certificate	LEON EFG Swiss fund basket	CH0205168468	7,048,924
	EFGGPH	Outperformance certificate	n/a	CH0222268333	4,617,180
	EFGFEE	Other participation	LEON EFG ETF and precious metals basket	CH0205167569	4,031,867
Reference bonds	VFGAZ	Reference borrower certificate (conditional capital protection)	CHF 3M LIBOR	CH0141509718	8,801,295
	VFGZR	Reference borrower certificate (conditional capital protection)	CHF 3M LIBOR	CH0141511318	8,768,868
	VFPBB	Reference borrower certificate (conditional capital protection)	CHF 3M LIBOR	CH0141511045	7,608,327
	VFRAL	Reference borrower certificate (conditional capital protection)	EURIBOR 3M	CH0141509791	7,219,994
	VFRTY	Reference borrower certificate (conditional capital protection)	CHF 3M LIBOR	CH0141504511	6,766,850
Leverage products	LTQAIY	Mini-future	n/a	CH0213859132	6,063,812
	LTQAIX	Mini-future	n/a	CH0213859124	5,148,652
	LTQCCX	Mini-future	n/a	CH0218791256	4,743,840
	LTQAJA	Mini-future	n/a	CH0213859157	3,596,427
	LTQAIZ	Mini-future	n/a	CH0213859140	2,659,259

Quelle: SIX Structured Products, November 2014

News, events and publications

Change in COSI Product Management



Christoph Schuler,
Senior Product Manager
Structured Products

At the end of August 2014, Matthias Müller left his role as COSI Product Manager at SIX Structured Products to work on a new project within SIX. Matthias had managed and helped shape the COSI segment for five years, leading it to great success. We would like to

thank him for all his work. COSI Product Management is now in the experienced hands of Christoph Schuler, Senior Product Manager Structured Products. Christoph has already been with SIX Structured Products Exchange Ltd for three years and brings with him a wide range of experience in the area of banks, exchanges and structured products.

Finanz'15

At the start of 2014, it was announced that the Fonds'14 Trade Fair and the Structured Products Trade Fair would merge as of 2015. The new joint "Finanz'15" trade fair will offer visitors an even wider range of products, financial knowledge and networking opportunities, and will take place for the first time in its new form on 4 and 5 February 2015 at the Kongresshaus in Zurich. So visit us at our stand (G.01) and get to meet our experts in person!

Trade fair details

Opening hours:

Wednesday: 10:00 - 18:00

Thursday: 10:00 - 17:00

Location:

Kongresshaus Zürich

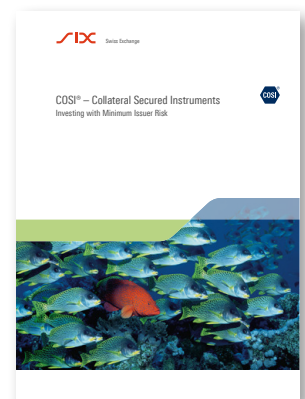
Claridenstrasse 5

8002 Zürich

Further information: www.finanzmesse.ch



The key facts at a glance:
the COSI fact sheet



The COSI information brochure
for more detailed information



Collateralization differences
at a glance

SIX Structured Products Exchange Ltd

Selnaustrasse 30

P.O. Box 1758

CH-8021 Zurich

www.six-structured-products.com/cosi

e-mail: structured-products@six-swiss-exchange.com

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