COSI®-NEWS

July 2015

Newsletter

Reference entities are sexy

> Editorial 01

> Apples and Oranges 03

> Diversifying Credit Risks using COSI Certificates with a Reference Entity 05

> Development since Launch 07

> Interview with Eric Blattmann 08

> Overview of top products 10

> News, events and publications 11

Dear reader

As far as the Swiss market is concerned, the scrapping of the euro cap was the most drastic event since the publication of the last COSI newsletter in December 2014. But there has been plenty of activity in the 2015 financial year already – bringing the record low volatility levels of the previous year to an abrupt end. The credit ratings and credit spreads of several banks have also been changing. Without going into details, we are currently in a market environment with ideal conditions for an anti-cyclical product feature like COSI, so there should be growing demand for it. Well, in theory anyway. In practice, the COSI segment of SIX Structured Products has continued to lose ground. Details can be found in our COSI statistics on pages 7 and 10.

Part of this decline is due to the low or negative interest rates. Against the backdrop of low coupons/yields, the costs of the COSI collateral feature gain more weight. The launch of TCM by SIX® in 2014 saw a further collateral solution for professional investors that can reduce the hedging costs of an issuer default by means of flexible, non-standardized structuring options. However, this requires investors in TCM products to be willing to lower their expectations in relation to COSI collateralization. The subtle but significant differences between the two SIX collateral solutions are addressed in the lead article starting on page 3.

The article on page 5 looks at the advantages of COSI collateralized investment products with reference entities and shows how they can be used to efficiently control credit risks in the securities portfolio.

Consequently, it is no surprise that around a third of the outstanding

Interview with Eric Blattmann, Bank Vontobel AG

"Investors in many other countries can benefit from the advantages of COSI products."

> 08

Swiss Exchange

COSIs were issued in the form of certificates with a reference entity. Bank Vontobel is a clear leader in this segment, which is why we interview Eric Blattmann, Head of Public Distribution Financial Products, on page 8.

We hope these articles will give you informative yet easily digestible food for thought in the summer heat.

Your SIX Structured Products team

Apples and Oranges

COSI and TCM are similar, yet in some respects entirely different collateral solutions from SIX. "Apples" and "oranges", almost. Although this common expression suggests we should avoid comparing the two fruits, we're going to do it anyway. The differences are subtle and little-known, but overall, they address different investor profiles.

First, let's look what they have in common: With both collateral solutions, as a reliable and neutral party, asks for collateral equivalent to the value of the issued structured product from the issuer or a named collateral provider. Both the collateral and the structured product are thereafter valued every trading day and any difference in value is offset by claiming or returning collateral. In the event of an issuer default, its collateral is liquidated and distributed to the investors on a pro-rata basis.

Now to the key differences: A central element of COSI protection is the standardized framework agreement with all COSI issuers and collateral providers. It ensures that all COSI products meet the same high security standard. By contrast, the agreement for TCM grants the issuers a certain degree of freedom in specific contractual aspects. As a result, a TCM-collateralized product can only be compared with the TCM products of another issuer to a limited extent in terms of the residual risk of loss. So to speak, we are actually comparing apples with different types of such as navel or moro.

The contractual flexibility of TCM is specifically apparent when defining the collateral schedule, i.e. the eligible assets for pledging, as well as the applicable fluctuation reserves (known as "haircuts"). For instance, for TCM products, the collateral provider can deposit securities of all grades and asset classes with no discount for fluctuation reserves. By contrast, with COSI the eligible assets are heavily restricted and associated with fluctuation reserves. Specifically, only recognized securities that fulfill specific liquidity and/or creditworthiness criteria are eligible for collateralization purposes, i.e. government and corporate bonds that meet the SNB criteria for repo-eligible collateral permissible up to the end of 2014, European blue-chip stocks, and cash deposits in the major currencies (CHF, EUR, USD, GBP, JPY). The levels of the applicable fluctuation reserves vary according to asset class and grade. For instance, the haircut is 10% for shares, 2% and 5% respectively for government and corporate bonds, and 0% for cash deposits. In addition, with COSI, potential cluster and liquidity risks in individual pledged assets are avoided by means of concentration limits. For example, a maximum of 5% of the issue volume of a single corporate bond can be deposited as collateral. By contrast, there are no fixed concentration limits with TCM.

With both collateral solutions, the deposited collateral is valued every trading day on the basis of traded prices. However, the valuation of the collateralized COSI products is based on different valuation mechanisms. With TCM products, the prices provided by the issuer are generally used to calculate the amount of the assets to be pledged, whereas with COSI, the calculated prices ("fair values") of two independent agencies are additionally incorporated in the valuation as reference values. The use of fair values counters any potential undervaluation of the COSI or any shortage of collateral.

Finally, the TCM agreement also provides flexibility when defining liquidation events, while in the COSI agreement, these are thoroughly defined in the investor's favor.

As explained in the introduction, the stated special features of COSI and TCM address different investor requirements and profiles. Because these special

Asset classes	Number of COSIs
Bonds	37
Commodities	24
Equities	789
Forex	5
Money market/swaps	235
Precious metals	16
Real estate	1
Various asset classes	58
Total	1,165

Source: SIX Structured Products, June 2015 features are little-known and, in some cases, hard to understand, uninitiated investors may run the risk of choosing the collateral solution that is less able to meet their individual need for security. The following principle can serve as a guideline here: TCM is primarily intended for use among professional market participants, while COSI is also particularly suitable for private investors.

SIX achieves this segmentation by providing TCM products for institutional OTC trading on the bilateral trading platform XBTR[1]. COSI products are now established in trading on SIX Structured Products and other regulated securities exchanges that additionally give increased investor protection in trading to private investors in particular. What is more, they save private investors the trouble of having to examine and get familiar with the issuer-specific TCM agreements, while professional investors can specifically benefit from the greater flexibility and potentially lower costs of TCM collateralization.

Ultimately, apples and oranges are more similar than they first appear, and we hope that this comparison between them in the context of the two SIX solutions has made things clearer when it comes to choosing the right type of collateralization.

(1) XBTR, the unregulated bilateral trading platform, gives SIX Structured Products participants the opportunity to set up, trade and settle structured products over-the-counter in a fully automated process via the proven SIX infrastructure.

Diversifying Credit Risks using COSI Certificates with a Reference Entity

Despite all the political uncertainty in the eurozone, the US economy seems to be making a slow but steady recovery. Positive economic growth prospects for the coming year also seem to be emerging in the United Kingdom, which is not a member of the eurozone. Against the backdrop of this essentially good news, the IMF warned against a liquidity shock on the bond markets in its report on economic development forecasts for the next three years – although this largely went unnoticed. With interest rates being low, and even negative in some places, investors are predominantly opting for higher-yield bonds. This is the only way to get a positive return on capital employed, at least in nominal terms. Consequently, issues of risky corporate and government bonds have achieved record turnover rates.

If the unprecedented period of zero interest rates in the USA comes to an end, this transitional phase could expose investors to unimagined and hitherto unparalleled risks. What sort of risks are involved here?

As soon as the US Federal Reserve decides to further reduce the huge expansion of the money supply, this could trigger an unintended trend on the bond markets. We would experience a transition from an economy dependent on the liquidity provided by the central bank to a self-reliant economy set for long-term growth. The same probably also applies to the eurozone.

As soon as the restricted money supply causes interest rates to rise again, interest rate expectations of all participants are likely to change rapidly. Interest rate rises are known to progress in cycles, and we would therefore be just at the start of a gradual rise in interest rates. In addition, against a backdrop of rising refinancing costs, there would be a reassessment of credit risks. This would significantly change the yield curve after a very long period of almost zero interest rates.

And this at a time when investor portfolios are still loaded with bonds, ultimately leading many investors to want to sell their bonds again. As it will still be unclear for how long interest rates will continue to rise, only a few investors are willing to invest large volumes in bonds.

As a result, rising interest rates would lead to a surplus of bond sellers. This would lead to a liquidity bottleneck – there could even be a liquidity shock on the markets for bonds and reference bonds. The IMF has pointed out that these liquidity risks have not been adequately examined in the current portfolios of investors. Once assessed correctly, the investors may face unforeseen losses on book values.

How can investors protect themselves against these liquidity risks more effectively?

Investors who as part of their conservative investment strategy have overweighted bonds in their portfolios in order to achieve a sound yield have the opportunity to replace these bonds with liquidly traded COSI products on reference entities. This has the following advantages:

Firstly, structured products on reference entities give even conservative investors the opportunity to achieve a higher yield on their investment by choosing a specific reference entity.

Secondly, with a COSI product, as well as protecting themselves against the risk of issuer default, conservative investors can additionally diversify the credit risks in the portfolio more effectively (often, borrowers from the financial sector are particularly overrepresented).

A third factor is the liquidity of COSI boosted by constant market-making. The COSI collateralization mechanism particularly involves a market-making obligation that, if not fulfilled, can in extreme cases lead to liquidation of the entire COSI portfolio or the deposited pledged assets of an issuer. This is intended to ensure that the issuers continuously have sufficient liquidity for COSI sellers.

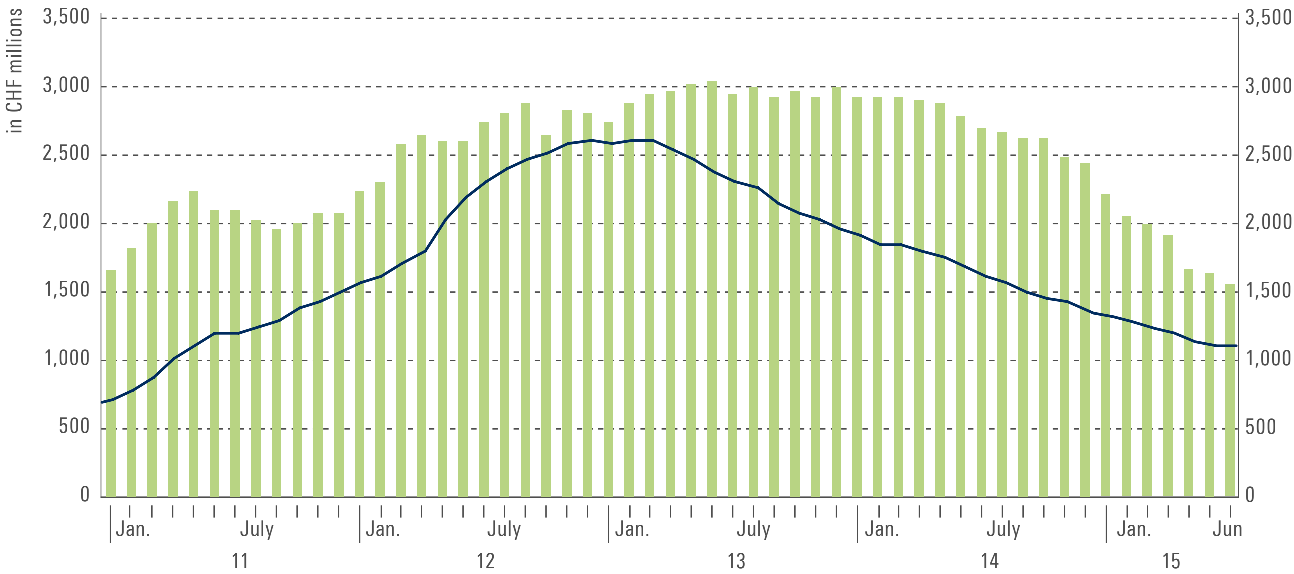
Further protective mechanisms ensure that sufficient liquid pledged assets are available should a liquidation event arise.

COSI certificates on reference entities therefore provide conservative investors with an effective mechanism that reduces the issuer risk, can diversify a possible overweighting of credit risks in the finance sector and can protect against liquidity risks.

Development since Launch

Development since the Start of 2015

The number of collateral-secured certificates has been in decline for some time. At the end of June 2015, 1,165 COSI products were tradable on SIX Structured Products. The deposited collateral volume was not immune to this development. At present, seven issuers with an outstanding volume of CHF 1.58 billion are active in the COSI segment.



Source: SIX Structured Products, June 2015

COSI issuers at a glance

Issuer	Capital Protection	Yield Enhancement	Participation	IP with Reference Entity	Leverage	Total
Credit Suisse	4	0	0	0	0	4
EFG International	61	33	18	8	2	122
J. Safra Sarasin	0	6	3	0	0	9
Julius Bär	0	3	29	0	0	32
Leonteq Securities	95	300	133	10	5	543
Merrill Lynch	0	0	1	0	0	1
Vontobel	0	103	8	343	0	454
Total	160	445	192	361	7	1,165

Source: SIX Structured Products, June 2015

Interview with Eric Blattmann

Eric Blattmann

Eric Blattmann is Head of Public Distribution Financial Products at Bank Vontobel AG. He took a Master's degree in Business Studies at the University of St. Gallen, majoring in finance & capital markets. His past employers include Derivative Partners Holding AG (founding member), ABN AMRO Bank and Merrill Lynch Capital Markets.

Eric Blattmann, Bank Vontobel AG

What reasons lay behind the decision to launch COSI products with reference entities?
Reference entity products make credit risks "investible", and investors can benefit from an attractive yield contribution depending on the selected borrower. At Vontobel, we offer products with reference entities only in conjunction with COSI, as this is the only way to minimize the default risk. Without the systematic COSI collateralization, investors would introduce two borrower risks – that of the reference entity and that of the issuer – into the portfolio every time they bought a reference entity product. So the interesting thing is that ultimately, the default risk of the issuer is virtually replaced by that of the reference entity.

With the COSI floored floater, Vontobel recently started issuing products with a basket of up to five reference bonds. What happens with the credit risks here? How and with whom have these products become established?
The products have quickly become established among private and institutional investors. The welcome surge in demand started soon after the first product was launched. COSI floored floaters with a bond basket as reference entities allow diversification of the default risk with just one transaction. For example, if the basket contains five reference bonds and a reference entity defaults, the nominal and the coupon are reduced by no more than 20% with the basket product.

What products are available in combination with a reference bond?
All of them, essentially.

"So the interesting thing is that ultimately, the default risk of the issuer is virtually replaced by that of the reference entity."

What is the target clientele of COSI products with reference bonds?
Essentially, all types of investor. As always, the essential requirement here is that the risk profile of the product is in line with the risk propensity of the investor. In addition, before buying, investors should give considerable thought to the default risk of the borrower, understand it and ultimately be ready to enter into it knowingly.
Nominal value repayment is guaranteed unless there is a default or repayment event that would lead to premature repayment. As with a bond, the value of the floored floater may fall below the face value during the term.

Which borrowers are currently available at Vontobel, and how would you describe the sector mix?
Vontobel products with over 70 different reference entities are currently available. The borrowers originate from various sectors. For example, there are insurance companies, carmakers, banks, technology and industrial companies and governments. However, the focus has recently been on borrowers in the commodities sector. Because of the fall in commodity prices, premiums for the credit risk of energy, industrial and precious metal companies in particular have risen, leading to attractive terms for reference bond products in the primary market as well as sound entry opportunities for corresponding products in the secondary market.

What criteria do you use to put together the bond pool?
The main factor is the yield contribution that can be achieved via the credit risk of the reference entity. A second but no less important selection criterion is the borrower quality, which is evaluated on the basis of the credit ratings and various fundamental data. This includes profitability, the leverage ratio and the liquidity of the company. Accordingly, selection is carried out on the basis of the credit risk premiums (CDS levels) and the quality characteristics of the borrower. On issue, only borrowers with an investment-grade rating will be considered. Most of the reference entities of newly launched products are in the "BBB" bracket, as companies with better ratings are not attractive in terms of yield at the moment. During the product term, there is a chance that the rating may fall below investment grade in the context of a decrease in credit quality.

Therefore, the credit quality of the reference entity should be dealt with before the investment as well as across the term. At Vontobel, we provide assistance with this. For instance, with "Schuldner-Check", we recently created a new section in our German-only derinews magazine in which our Credit Research department highlights the changes in our universe of reference bonds. One well-known recent case study related to the Russian oil and gas giant Gazprom. The derinews section "Schuldner-Check" is also published in our newly launched derinews blog at derinet.ch, making it even more accessible.

What yield advantages can be achieved with a reference bond?
It is probably better to ask when an investment in a reference entity product is more advisable than a direct investment in a bond of the reference entity. This mainly depends on the added yield. Let's take the reference entity Abengoa as an example: A 3-year floored floater in US dollars with Abengoa as the reference entity currently offers a yield of 8.2% p.a., compared with 7.13% p.a. for a direct investment in the bond. So this makes for a more attractive yield as a result of the currently higher credit risk premium. Further investment requirements may cause an investor to prefer a reference entity product to a bond investment. For instance, reference entity products can expand the range of investments if the bond is not available in the preferred investment currency and the investor does not want to bear the currency risk. The structure of the floored floaters with a reference entity also makes it possible to benefit from the attractive minimum coupon while also participating in a possible rise in the short-term reference interest rate. This brings another strength of this type of product to the fore: Buying a floored floater with a reference entity can reduce the interest-rate risk of a portfolio made up of conventional bonds.

What structures are generally in demand as COSI?
Mainly floored floaters with COSI with a reference entity. In the current climate of low/negative interest rates, many investors deem them to be a suitable yield product because of their attractive coupons. Floored floaters also leave open the possibility of benefiting from a rise in a short-term reference interest rate during the term.
As a result of the conditional capital protection at the end of the term, the structure also suits lots of different investor profiles – including those with low risk propensity. But beware: It depends on the reference entity, which is ultimately responsible for capital protection at the end of the term.

Do you see any opportunities/possibilities for COSI in other markets?
Absolutely, as investors in many other countries can benefit from the advantage of COSI products.

Many thanks for taking part in this interview!

Overview of top products

SSPA Category	Symbol	Sub Category	Underlying	ISIN	CHF Turnover
Capital Protection	EFGFJO	Capital protection with Participation	Forex EUR/CNY / Forex EUR/MXN	CH0205715474	1,404,717
	EFGFWV	Capital protection with Coupon	Nestlé N / Novartis N / Roche GS / Swisscom N / Zurich Insurance Group AG	CH0208025004	1,198,551
	BCNCH	Capital protection with Coupon	AT&T Inc. / Abbott Laboratories / Astrazeneca / BNP Paribas S.A. / Coca-Cola Co.	CH0110879472	1,184,491
	LTQAKW	Capital protection with Coupon	Holcim N / Nestlé N / Roche GS / Swisscom N / Zurich Insurance Group AG	CH0215666063	913,515
	EFHAM	Capital protection with Coupon	ABB N / Credit Suisse Group N / Nestlé N / Roche GS	CH0110622609	844,483
Yield Enhancement	LTQBNW	Express Certificate	EURO STOXX 50 PR Index	CH0228509151	17,074,380
	LTQAVD	Express Certificate	EURO STOXX 50 PR Index	CH0222933399	13,075,434
	VONMLG	Barrier Reverse Convertible	Nestlé N / Novartis N / Roche GS	CH0241730875	5,237,838
	LTQBWE	Barrier Reverse Convertible	EURO STOXX 50 PR Index / IShares MSCI South Korea Index Fund / S&P 500 Index	CH0228511330	4,325,564
	LTQBWF	Barrier Reverse Convertible	EURO STOXX 50 PR Index / IShares MSCI South Korea Index Fund / S&P 500 Index	CH0228511348	4,314,027
Participation	JBCOC	Tracker Certificate	JB Fund on Physical Gold (USD)	CH0212293267	5,205,091
	EFGFGM	Tracker Certificate	CREDIT SUISSE REAL EST.FDLIV. INHABER-ANTEILE O.N. / CS SIAT / Credit Suisse	CH0205168468	4,209,238
	LTQEGM	Outperformance Cert.	Medtronic Inc.	CH0245340754	2,509,502
	JOPHV	Outperformance Cert.	Johnson & Johnson	CH0242020987	2,419,340
	VZSPI	Bonus Certificate	S&P 500 Index	CH0241732269	2,157,136
Reference Entities	VFBRA	Cert. with Conditional Capital Prot.	4.25 Federative Republic of Brazil 07.01.2025 / EURIBOR 3M	CH0141510914	26,319,110
	VFASG	Cert. with Conditional Capital Prot.	5.125 Assicurazioni Generali S.p.A. 16.09.2024 / LIBOR 3M CHF	CH0141509692	21,460,877
	VFRAL	Cert. with Conditional Capital Prot.	5.125 Assicurazioni Generali S.p.A. 16.09.2024 / EURIBOR 3M	CH0141509791	12,721,032
	VFGLE	Cert. with Conditional Capital Prot.	6.5 Glencore Finance Europe S.A. 27.02.2019 / EURIBOR 3M	CH0141506516	10,330,056
	VFGLC	Cert. with Conditional Capital Prot.	6.5 Glencore Finance Europe S.A. 27.02.2019 / LIBOR 3M CHF	CH0141506508	9,705,303
Leverage Products	LTQAQK	Warrant	Sony Corp.	CH0218789672	183,928
	LTQBNC	Warrant	Forex CHF/HUF	CH0218791058	129,723
	EFGFWM	Warrant	Forex USD/JPY	CH0198382233	112,918
	SBOND2	Mini-Future	4 Swiss Government Bond 02.2023	CH0133270600	44,063
	EFGFYL	Warrant	Hitachi Koki Co Ltd.	CH0210575855	1,335

Source: SIX Structured Products, July 2015

News, events and publications

ETPD Stream at the Lugano Fund Forum

The event series "Exchange Traded Product Days", or ETPD for short, hosted by SIX Swiss Exchange and SIX Structured Products, provide exciting insights into current developments in passive financial investments. For the next edition of the ETPD stream at the Lugano Fund Forum, we have yet another exciting program. This year's keynote speech for the ETPD stream will be delivered by Professor Joseph E. Stiglitz, winner of the Nobel Prize for Economics in 2001.

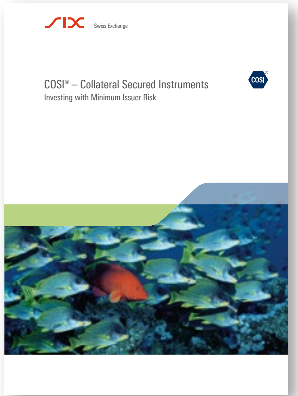
Further information will be published at **www.etpd.ch** as soon as it becomes available.

Event dates

Opening hours:	Monday November 23, 2015 9:00 a.m. to 6:30 p.m. Tuesday November 24, 2015 9:00 a.m. to 5:30 p.m.
Location:	Palazzo dei Congressi Piazza Indipendenza 4 6900 Lugano, Switzerland

Further details: www.luganofundforum.ch

The key facts at a glance: the COSI fact sheet



The COSI information brochure for more detailed information

Collateralization differences at a glance

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