INTERNATIONAL **BANKING** REVIEW

2023 / 24

Beaumont Capital Markets

SWITZERLAND

Key developments & the latest trends in Switzerland – from your perspective

LOYENS & LOEFF

BIO

Judith Raijmakers heads the Swiss Banking & Finance team at Loyens & Loeff. She focuses on banking & finance matters including secured lending, debt (re)structuring, debt issuances and financial regulatory work.

Judith Raijmakers
Partner

judith.raijmakers@loyensloeff.com

+41 43 434 67 00

www.loyensloeff.com

LOYENS & LOEFF
Law & Tax

LOYENS & LOEFF

BIO

Christine Hohl is a counsel in the Swiss Banking & Finance team at Loyens & Loeff. She focuses on financing transactions, including acquisition financing, asset financing, project financing, real estate financing as well as debt issuances and securitisations.

Christine Hohl
Counsel

christine.hohl@loyensloeff.com

+41 43 434 67 66

www.loyensloeff.com

LOYENS & LOEFF
Law & Tax

Macroeconomics & Geopolitics – From the Covid-19 pandemic to the war in Ukraine

After a stellar 2021 came a turbulent 2022: Following on from supply chain issues juxtaposed to a strong pick-up in demand after the Covid-19 pandemic, global recovery saw a significant setback as a result of the outbreak of war in Ukraine in February 2022. It lead to an escalation of geopolitical tensions, a rise in volatility and a fall in global share prices with the astronomic increase in energy costs and commodities prices now encouraging record rates of inflation.

> “
> With traditional lenders exercising caution in this environment, private debt funds became a viable alternative.

Whereas the Eurozone and the UK (and temporarily also the US) were hit by double-digit figures, inflation rates in Switzerland remained comparatively low but, in February 2022, exceeded the Swiss National Bank (SNB)'s inflation target of 2% for the first time since the 2008 credit crisis. As far as economic growth is concerned, the Swiss State Secretariate for Economic Affairs expects a growth of Swiss GDP in 2023 of just 1.1%, down from 2.2% in 2022 and 4.2% in 2021. At the moment, it is not possible to say whether a recession is indeed likely in Switzerland rather than just a slowdown in growth.

In the acquisition and leveraged finance space, primary issuances slowed down significantly with declines of almost 50% in the first half of 2022 from record highs in the same period in 2021. With traditional lenders exercising caution in this environment, private debt funds became a viable alternative. However, such funds also seem to have become more selective with a greater focus on safer sectors less exposed to supply chain issues. This has already led to an increase in pricing, less leverage and a move away from covenant light financing documentation towards more conservate terms and more protection for lenders.

Private and foreign banks in Switzerland with their strong focus on investment business were particularly affected by the negative performance of global stock markets which led to an 11% decline in their assets under management. The challenging market environment, together with a considerable number of new regulations and additional disclosure obligations both in Switzerland and the EU (see below) have also shifted the focus of many banks from growth and innovation to cost-cutting, risk and compliance.

Interest rates – From LIBOR to SARON & from free money to a renewed margin business and the March bank failures

The London Interbank Offered Rate (LIBOR) for Swiss francs was replaced, as of 1 January 2022, with alternative risk-free rates, the most common of which being the Swiss Average Rate Overnight (SARON). The transition of banks' loan portfolios from LIBOR to SARON in Switzerland seems to have gone relatively smoothly and certain particularities in the calculation methodology used in the Swiss market in the early stages of the transition seem to have given way to the international standard suggested by the Loan Market Association (LMA).[1]

Another development linked to the replacement of Swiss Franc LIBOR by SARON (or an alternative risk-free rate) is the changing concept of break costs, the rationale for which does not really apply in the case of risk-free rates which are calculated on a daily basis and are not an approximation of the costs to a bank of maintaining a loan over a certain interest period. The standard that appears to have developed in the Swiss market is a combination of a limitation on permitted prepayments and a fee payable upon prepayment.

1. In the early stages of the transition from Swiss Franc LIBOR to SARON, the calculation methodology frequently used, as recommended by the Swiss National Working Group on Swiss Franc Reference Rates, was "cumulative compounded SARON" which differed from the daily non-cumulative compounded rate recommended by the LMA and reflected in its form of rate switch documentation. However, by now the LMA recommended calculation methodology is being applied not only where there are non-Swiss participants in the lending syndicate or in multicurrency facilities but even in purely domestic new lending transactions.

While the rapidly increasing rates of inflation at the beginning of 2022 were initially considered by many as a temporary base effect following the re-opening of the global economy after the COVID-19 pandemic, inflation continued to rise in Q1 and Q2 of 2022 and central banks were eventually obliged to increase their interest rates. The Swiss National Bank (SNB) ended its negative interest rate regime after more than seven years in summer 2022 with the current SNB interest rate (set on 24 March 2023) being 1.50%.

This means that money again has its price and banks might be able to return to higher margins in the extremely important interest margin business.

However, the risks of rising interest rates have become very palpable with the collapse of Silicon Valley Bank (SVB) on 10 March 2023, the largest U.S. bank failure since the 2008 financial crisis. SVB held large portfolios of US government bonds which had significantly lost in value due to interest rate rises. Despite SVB's collapse, central banks continued to hike interest rates in March 2023, albeit by only 0.25% in the case of the US Fed and the Bank of England and 0.50% by the ECB and the SNB.

SVB's collapse was preceded by that of Silvergate Bank on 8 March and followed by that of Signature Bank on 12 March, both of which were heavily focused on crypto assets. On 16 March, a group of big US banks injected USD 30 billion into First Republic Bank which was seen as at risk of failure.

A little closer to home, Credit Suisse's share price dropped by as much as 30% on 15 March following an announcement by its largest shareholder, Saudi National Bank, that it would not make any further investment in the bank after Credit Suisse revealed that it had identified "material weaknesses" in its financial reporting. A statement of support from the SNB later that day and the announcement by Credit Suisse overnight that it would borrow up to CHF 50 billion from the SNB only temporarily succeeded in calming stock markets and so, over the weekend of 18/19 March, the Swiss government, the Swiss Financial Market Supervisory Authority (FINMA) and the SNB together with the two banks involved negotiated the takeover of Credit Suisse by its long-term rival UBS based on emergency legislation and backed by further liquidity assistance from the SNB and government guarantees.

Whether the risk of contagion in the banking sector has been successfully contained remains to be seen.

The rejection of the Swiss withholding tax reform - A missed opportunity

Contrary to many other countries, there is no withholding tax in Switzerland on interest payments in respect of private and commercial loans (including arm's length intragroup loans). However, Swiss federal withholding tax, at a current rate of 35%, is imposed on interest paid to Swiss or foreign investors on bonds and other forms of collective debt issued by or on behalf of Swiss tax-resident issuers. While Swiss interest withholding tax is generally recoverable by Swiss investors and foreign investors that benefit from double tax treaties, the recovery process might be lengthy and burdensome. As a result, the investor base for bonds issued by Swiss issuers is often limited to Swiss investors or bonds are issued through a foreign (often a Luxembourg) subsidiary. Credit financings may be subject to the same treatment if the number of non-bank creditors under such financing exceeds ten or the total number of creditors of a Swiss borrower exceeds twenty (the so-called Swiss 10/20 non-bank rules).

"
Whether the risk of contagion in the banking sector has been successfully contained remains to be seen.

In order to strengthen Switzerland's position as a financial market and treasury centre, the Swiss Federal Council decided in September 2020 to abolish Swiss withholding tax on interest payments (except for interest payments to Swiss resident individuals on domestic bank accounts and deposits). However, a referendum was initiated against such legislative proposal and it was rejected in September 2022 by 52% of voters. Hence, an important opportunity to reform Switzerland's withholding tax regime was missed and the Swiss 10/20 non-bank rules will continue to need to be considered when structuring financing arrangements for Swiss borrowers and, in certain circumstances, Swiss guarantors.

Sustainability – From trend to structural change

> "Swiss regional banks which, in 2021, were still reluctant to confront the topic are now fully committed to integrating sustainability at least in their investment advice.

A shift in perspective

According to the EY Banking Barometer 2023, 96% of banks surveyed (up from 89% the previous year) are taking sustainability into consideration in their advisory process, whereas 77% (up from 72% the previous year) are doing so in their lending decisions.

In particular, Swiss regional banks which, in 2021, were still reluctant to confront the topic are now fully committed to integrating sustainability at least in their investment advice.

Sustainability (self-)regulation

Regulation certainly plays its part in banks taking account of sustainability factors in both their investment and lending business.

In its **Action Plan** for the period 2021-2023, the Swiss Federal Council adopted a national sustainability agenda which places the financial sector at the heart of the **2030 Sustainable Development Strategy.**

Also in June 2022, the Swiss Federal Council launched the **Swiss Climate Scores** for climate transparency in financial investments which are intended to provide institutional and private investors with comparable and meaningful information on the extent to which their financial investments are compatible with international climate goals. The use of the Swiss Climate Scores is voluntary and the indicators range from greenhouse gas emissions and exposure to fossil fuel activities over transition to net zero and management of net zero to credible climate stewardship and global warming potential.

Again, in the same month, the **Swiss Bankers Association** published both its 'Guidelines for financial service providers on the integration of ESG-preferences and ESG-risks into investment advice and portfolio management' and new guidelines for mortgage providers on the promotion of energy efficiency.

In addition, the counterproposal to the Responsible Business Initiative has led to changes in the Swiss Code of Obligations (cf. articles 964a et seqq.) which will increase non-financial reporting obligations for Swiss banks and other large corporates from 2024 (for the 2023 financial year). In-scope companies (public interest companies with an annual average of at least 500 full-time positions and a balance sheet of CHF 20 million or revenues of CHF 40 million) must report on an annual basis on environmental (in particular, climate-related), social and labour matters as well as on human rights and anti-corruption.

In September 2022, the **Asset Management Association Switzerland** (AMAS) established a self-regulation for sustainable asset management in the form of a principle-based framework on transparency and disclosure for sustainability-related collective investment vehicles which will enter into force in September 2023. The framework is binding on AMAS members only but can be adhered to by non-members on a voluntary basis. Importantly, it recognises the possibility to apply comparable foreign standards which are not limited to EU rules.

Additionally, in November 2022, the Swiss Federal Council adopted its **Ordinance on Climate Disclosures** pursuant to which climate reporting for large Swiss companies will come into force in 2024 and require companies to publish their climate risks based on the recommendations of the Task Force on Climate-Related Financial Disclosure (TCFD). For the largest Swiss banks and insurance companies which fall into FINMA's supervisory categories 1 and 2, these obligations have already been in force since July 2021 under revised FINMA Circular 2016/1.

In the EU, the main focus of regulation is on the disclosure of climate and sustainability related information, including in the financial services sector. For Swiss banks that want to sell their financial products in the EU, the **Sustainable Financial Disclosure Regulation** (SFDR) is already mandatory.

Notably, 66% of banks surveyed for the EY Banking Barometer 2023 think these regulations still need to be fleshed out further if sustainability in both lending and investment is to be credible.

From sustainability criteria in financing to financing sustainability

Whereas sustainability seems to be relatively firmly established in the investment business of Swiss banks, institutions are increasingly focusing on lending, in particular, mortgage lending, when expanding their sustainable product range.

However, when it comes to commercial lending, the focus of Swiss banks is still very much on risk, i.e. the exclusion of certain companies or sectors and the inclusion of ESG ratings in credit decisions and pricing (so-called sustainability-linked loans), rather on opportunities, i.e. the financing of corporate transformations and sustainability solutions (through green, sustainable or social loans). Whereas, in the case of sustainability-linked loans, which are constantly increasing in the Swiss lending market and are becoming more and more sophisticated in the process, the use of proceeds is not restricted or tied to a specific project and instead pre-defined key performance indicators and margin discounts or premiums are being used to encourage borrowers towards sustainability, green, sustainable or social loans restrict the use of proceeds to the financing of green, sustainable or social projects and might, therefore, not be suitable for medium-sized entities that do not have projects large enough for an independent structured loan. Additional challenges such as higher financial risk (at least in the short-term), a lack of standards, data availability and ratings (in particular, for SMEs), regulatory hurdles and sometimes still a lack of expertise, means that, when it comes to financing green, sustainable or social projects, new financing solutions may be needed. Among these are mezzanine instruments (with more flexible terms and covenants than senior debt and a debt-to-equity option for lenders), blended finance (i.e. a collaboration with the public sector where the state assumes certain risks and provides additional guarantees, insurances or subsidies to reduce risks for private lenders), specialised intermediaries (such as asset managers) or technological solutions (FinTech, DLT etc.).

When it comes to commercial lending, the focus of Swiss banks is still very much on risk.

Green Bonds

Contrary to a certain reluctance in the Swiss bank lending market to embrace green, sustainable or social loans, a considerable number of sustainable, green and even social bonds have been listed on the SIX Swiss Exchange. Also, in July 2022, the Swiss Confederation Green Bond Framework was introduced with a targeted issuance volume of several hundred million Swiss Francs per year and the first Green Confederation Bond for CHF 766 million was issued in October 2022.

Greenwashing

The topic of greenwashing has come under increased attention also from the Swiss regulator, FINMA, which issued Guidance 05/2021 on preventing and combatting greenwashing. For two-thirds of Swiss banks, however, the reputational risk associated with greenwashing is considerably more important than the risk of regulatory sanctions or legal disputes with customers. It is mainly foreign banks that attribute more weight to these consequences of greenwashing which may be due to such banks' experiences in other markets. In the US, for example, the Securities and Exchange Commission has already launched investigations into banks in connection with greenwashing and imposed multimillion dollar penalties.

Bankruptcies & restructurings - The elephant in the room

Alongside the worldwide increase of government debt, companies have also significantly boosted their debt ratios in recent years. The impact of such high debt on the economy was apparent in 2022 with credit defaults by companies such as Greensill, Evergrande, Archegos, Cineworld, Diamond Sports, Envision, Revlon and FTX and a leveraged loan default volume in the US that was three times higher than in 2021.

> "
> A slowdown in economic growth, rising energy and commodities prices, a drop in share prices and higher interest rates are creating a challenging environment for many companies.

In Switzerland too, a slowdown in economic growth, rising energy and commodities prices, a drop in share prices and higher interest rates are creating a challenging environment for many companies, in particular, those that were already reliant on governmental support to get them through the COVID-19 pandemic and that now find that loan financing is becoming again more difficult and more expensive.

Under the Swiss COVID-19 loan programme, loans with an aggregate volume of over CHF 17 billion were granted and a significant number of those are still outstanding. Apart from the argument that, by saving numerous Swiss companies from bankruptcy in 2020 and 2021, governmental support measures merely masked and continue to mask deeper structural problems in various sectors, it should be noted that a number of important restrictions apply to companies that continue to be financed by COVID-19 loans, in particular, in respect of the upstreaming of cash flows and the granting of upstream security and guarantees.[2]

According to Dun & Bradstreet's statistics on corporate insolvencies in Switzerland, there is a gradual increase in insolvency rates since 2020 (from 487 in 2020 to 637 in 2022) and 61% of banks surveyed in the context of the EY Banking Barometer 2023 expected to see a rise in credit defaults on their SME loan portfolios for 2023 (compared to 43% the previous year).

Whether the long-expected waive of corporate restructurings and bankruptcies will finally arrive in 2023 remains to be seen.

2. A borrower under a Swiss COVID-19 loan is, inter alia, restricted from paying dividends or repaying equity to its shareholders, granting or repaying loans to affiliated parties, refinancing intra-group loans or on-lending proceeds from COVID-19 loans to group companies outside of Switzerland.

LOYENS & LOEFF
Law & Tax

Further. Better. Together.

Loyens & Loeff
an integrated legal and tax law firm

Loyens & Loeff is an international law and tax firm with cross-border expertise in a wide range of sectors. Our specialists in our four home markets - Belgium, Luxembourg, The Netherlands and Switzerland - are recognised for their in-depth knowledge and unique approach, integrating law and tax.

Amsterdam, Brussels, London, Luxembourg, New York, Paris, Rotterdam, Tokyo, Zurich

loyensloeff.com