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Banking & Finance 2021

Switzerland: Trends & Developments
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Trends and Developments

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A Brief Overview of Banking and Finance in Switzerland

In Switzerland, as in many other jurisdictions, financial markets struggled in 2020 due to the COVID-19 pandemic. In March 2020, the Swiss Federal Council declared the “extraordinary situation” and introduced stringent measures, including the lockdown of schools, shops, restaurants, bars, and entertainment and leisure facilities. Most of these strict measures were lifted during summer 2020. However, during November 2020 through March 2021, certain measures were imposed again, but generally, restrictions were relatively light, as compared to other jurisdictions in Europe.

The Swiss government passed various regulations in response to the COVID-19 pandemic, including measures to avoid bankruptcies of businesses which were expected to arise as a consequence of the pandemic (eg, availability of an emergency moratorium for small and mid-cap size businesses of up to six months, subject to less formal requirements than a general composition moratorium, temporary standstill measures and others). Most of these regulations have been implemented into law that has been approved by parliament (even though such laws are currently the subject of a referendum).

In many industries, the EBITDA of corporate borrowers declined dramatically during Q2 of 2020. According to the Swiss State Secretariat for Economic Affairs, the Swiss GDP fell by approximately 8% in Q2 of 2020, which is the biggest decline since the start of the collection of quarterly data in Switzerland. There were, however, certain industries that were not affected by the outbreak of the COVID-19 pandemic or

even benefited, such as IT, the online and the pharma industries. Most industries recovered rapidly and in Q3 of 2020, the Swiss GDP was only 2% below pre-crisis level. Whilst the Swiss economy recovered since then quite well, certain industries continue to be heavily affected by the measures imposed in response to the COVID-19 pandemic (eg, the travel, tourism, and event industries, restaurants, etc).

As a consequence of the COVID-19 pandemic, there was a massive increase in liquidity needs for corporate borrowers, but the Swiss banking market and to some extent the capital market, with the support of the Swiss Confederation, the Swiss Cantons and the Swiss National Bank has been able to bridge such liquidity needs. Various programs have been set up for these purposes.

Effects of the COVID-19 Pandemic on the Swiss Lending Markets

Following the ordering of the first lock-down by the Swiss Federal Council on 16 March 2020, corporate borrowers were in crisis mode. It became obvious, that a large number of leveraged finance transactions would come immediately under distress and, depending on the industry, also corporate debt finance transactions with relatively low leverage were under pressure.

The banks in Switzerland acted very responsibly and there was essentially no opportunistic behavior of market participants. A huge number of transactions had to be amended. Normally, covenant holidays and in some cases even payment holidays have been granted. Leverage ratio covenants have often been replaced by liquidity covenants. Also, the restrictions applying

under the COVID-19 loan program had to be addressed, because the up-streaming of cash flows was restricted for those operating entities within a group that had borrowed under a state guaranteed COVID-19 loan (see also below).

Some borrowers had to be refinanced for purposes of ensuring the continuation of the business. In some instances, transactions were supported by the Swiss Confederation and the Swiss National Bank.

It remains to be seen what the mid and long-term impact of the COVID-19 pandemic will be, both on the market and on market practice. However, it is very remarkable that, with a few exceptions only, the Swiss debt financing market seems to be back on track. Of course, the continuing high level of liquidity in the market and the very low interest rates (currently, the Swiss National Bank continues to charge minus 75bps on sight deposits of banks) continue to be drivers in the market.

COVID-19 Loan Programme

In March 2020, only a week after the first lockdown had been ordered by the Swiss Federal Council, the Swiss COVID-19 Loan Programme has been set up by the Swiss Federal Council under an emergency ordinance (the COVID-19 Ordinance on Joint and Several Guarantees). The program aimed at supporting SMEs with immediate liquidity needs (as a consequence of the pandemic). Rapid access to liquidity facilities was granted. COVID-19 loans were granted between 26 March and 31 July 2021. As of 19 December 2020, the COVID-19 Ordinance on Joint and Several Guarantees has been transformed by Swiss parliament into a formal federal act. Accordingly, on 1 January 2021, the Swiss Federal Act on COVID-19 Credits with Joint and Several Guarantee entered into force.

COVID-19 loans were originated, disbursed and serviced by the Swiss banks.

Terms of the COVID-19 loans

Affected SME's were able to apply for COVID-19 loans in an amount of not more than 10% of their maximum annual turnover and in any event not more than CHF20 million. Furthermore, it was a requirement that the SME was incorporated before 1 March 2020, was not in bankruptcy or under a moratorium, was affected by the COVID-19 pandemic and did not receive any liquidity protection based on other emergency programmes. There are two different COVID-19 Loans: loans up to CHF500,000 ("COVID Loans") and loans in amounts between CHF500,000 and CHF20 million ("COVID Plus Loans").

COVID-19 loans up to an amount of CHF500,000 are fully backed by the Swiss Confederation and an interest rate of zero applies. COVID-19 loans have been granted without any credit check and have normally been paid out within hours only.

COVID Plus Loans are 85% backed by the Swiss Confederation. The remaining 15% credit risk is taken by the bank. Therefore, a normal credit approval process was necessary. Those loans provide for an interest rate of 0.5% per annum.

Statistics

According to data provided by the Federal Department of Economic Affairs, Education and Research, 136,716 COVID-19 loans (with an aggregate volume of roughly CHF14 billion and 1,134 COVID-19 plus loans (with an aggregate volume of roughly CHF3 billion) have been granted between 26 March and 31 July 2021. As of mid-September 2021, about CHF3 billion) have been fully repaid. The lending banks have drawn on the supporting guarantee from the Swiss Confederation in relation to COVID-19 loans in an amount of approximately CHF240 million.

There are relatively few actual or alleged cases of abuse as compared to the overall size of the program.

Restrictions

Borrowers of COVID Loans are subject to certain restrictions as the purposes of such loans is, in short, limited to ensuring continuity of the business. Whilst the restrictions under the Swiss Federal Act on COVID-19 Credits with Joint and Several Guarantee are more relaxed than under the emergency ordinance, certain key restrictions still apply. Hence, a borrower of a COVID-19 Loan must not:

- pay dividends or bonuses to shareholders or repay equity capital to shareholders;
- grant loans or repay loans or other obligations to affiliated parties, unless such loan or other obligation was pre-existing;
- refinance intra-group loans, except for pre-existing obligations for the payment of interest and amortisations;
- on-lend or make otherwise available of COVID-19 Loan proceeds to group companies outside of Switzerland, except for pre-existing obligations for the payment of interest and amortisations.

These restrictions are problematic for operating entities that form part of a larger group, where the group relies on cash flows generated by these operating entities. Debt servicing at the top level of a group becomes difficult where the operating entities are restricted to up-stream cash flows. Hence, borrowers are incentivised to repay COVID-19 loans rather sooner than later. Also, where group financing transactions had to be re-negotiated and covenant or even payment holidays have been granted by the lenders, the lenders normally insisted on a clear roadmap towards early repayment of the COVID-19 loans.

LIBOR Cessation

The London Interbank Offered Rate (LIBOR) will be discontinued for most currencies, including the CHF LIBOR, by the end of 2021 and the financial markets are transitioning to use risk free rates. On 4 December 2020, the Swiss Financial Market Supervisory Authority (FINMA) issued its LIBOR transition roadmap as FINMA Guidance 10/2020. According to this roadmap, lenders have been asked to determine which contracts and what volume are potentially “tough legacy” as they mature after 2021 and do not contain robust fallback clauses by no later than March 2021 and to amend relevant contracts ideally by 30 June 2021. In the CHF market, the Swiss Average Rate Overnight (SARON) was recommended by the National Working Group on Swiss Franc Reference Rates (NWG).

Larger Swiss financial institutions started the process of amending existing syndicated credit facilities agreement in early 2021 and, in the meantime, a fair volume of deals have been successfully amended. Also, since around June of this year, new deals introduced the SARON from the outset of the transaction without any rate switch mechanism being applicable. Whilst parties mostly follow the guidance and template agreements provided by the NWG, a certain standard has evolved during the last couple of months.

Lookback with observation shift

Whilst various methods for calculating the compounded SARON are available, the Swiss domestic syndicated lending market clearly focused on the method “look back with observation shift” with period of five RFR business days.

Calculation of compounded SARON

In the Swiss domestic market, the compounded SARON is typically calculated on the basis of the “cumulative compounded SARON” as recommended by the NWG. The compounded daily

rates are cumulated and only one interest calculation will occur in relation to each interest period. However, as this calculation methodology differs from the methodology applied by the Loan Market Association (LMA) and reflected in the LMA recommend form rate switch documentation (ie, daily non-cumulative compounded rate), non-Swiss banks and lenders are not very familiar with the Swiss approach. Hence, in situations where there are non-Swiss financial institutions in the syndicate, the LMA concept is normally applied and the compounded SARON is calculated based on the daily non-cumulative compounded rate. Also, in multicurrency facilities agreements, in order to avoid that different methodologies are implemented in one facilities agreement, the daily non-cumulative compounded rate is used for calculating interest on a daily basis.

As mentioned, under the cumulative compounded SARON concept, interest will only be calculated once at the end of the interest period. However, upon a prepayment, the calculation of interest will have to be advanced and the standard clauses that evolved address this by introducing a concept of “shortening of interest periods” which at the same time results in a shortening of the observation period.

Break costs

In transactions where LIBOR applies or applied, the borrower was under an obligation to pay break costs to the lenders upon prepayment of a loan during an interest period. The break cost concept assumes that each lender matches the funding of its loans to the actual term of the respective loans and potentially suffers a loss in case the interest which a lender should have received for the remainder of the interest period exceeds the actual amount which a lender would be able to obtain by redepositing the money for the period from prepayment of the loan until the last day of the interest period.

This rationale does not apply where a loan references risk free rates, as risk free rates accrue on a daily basis and are not an approximation of the cost to the bank of maintaining the loan over the interest period. Nevertheless, the agent and lenders may incur a loss if their funding arrangements for maintaining a loan are interrupted by a prepayment and for any administrative burdens. There are different ways to address this.

A prepayment could trigger a one-time fee per prepayment or a portion of the margin could still be due for the remainder of the interest period. Alternatively, the number of voluntary prepayments could be limited during a year for purposes of avoiding that revolving facilities are used almost as overdraft facilities.

Rate switch date

Whilst all transactions must switch to the risk-free rates before the year end, Swiss banks are already trying to implement the switch in September or October.

Outlook

Currently, the market approaches the endgame of the LIBOR transition. Conceptually, market standards have evolved, but latest statistical data from the FINMA suggests that still a fair number of transactions will have to go through the amendment process for the introduction of SARON as new reference rate. Still, the Swiss lending market appears to be ready for the cessation of the CHF LIBOR by the end of 2021.

Debt Funds

Debt funds continue to be active in the Swiss market and it appears that the number of leveraged finance transactions involving debt funds continues to increase. However, the market share of debt funds continues to be lower than in other jurisdictions, such as Germany or the UK.

Whilst there is no exact data available, reasons for such relatively low market share of debt funds in the Swiss lending market could be the following:

- Swiss banks continue to be very active in the market and are normally able to offer attractive rates;
- debt funds tend to accept higher leverages as banks and accept certain other very attractive terms (eg, no equity requirement for permitted acquisitions, no limitation of permitted acquisitions (subject to leverage test only), etc), however, Swiss banks have become more flexible in this regard as well; and
- whilst the documentation suggested by debt funds normally provides for more flexibility, Swiss banks are still considered to be reliable partners that are reasonable in granting waivers and offer pragmatic and flexible solutions upon commercially justified request.

Swiss Withholding Tax

Current status

Unlike most other countries, Switzerland does not levy withholding tax on interest paid on private and commercial loans (including on arm's-length inter-company loans). Rather, 35% Swiss Federal withholding tax is levied on interest paid to Swiss or foreign investors on bonds and similar collective debt instruments issued by or on behalf of Swiss resident issuers. According to the Swiss Federal Tax Administration and the relevant regulations, credit facilities also qualify as collective debt instruments, if syndicated outside of the banking market and, as a result, there are more than ten non-bank lenders in the syndicate.

International capital markets do not typically respond well to bonds subject to Swiss withholding tax. Therefore, the investor base is relatively often limited to Swiss investors, or, in the case of Swiss multinational groups, bonds are

issued through a foreign subsidiary. However, the Swiss Federal Tax Administration (SFTA) reclassifies such foreign bonds into domestic bonds if the amount of proceeds used in Switzerland exceeds certain thresholds (ie, the combined accounting equity of all non-Swiss subsidiaries of the Swiss parent company and the aggregate amount of loans granted by the Swiss parent and its Swiss subsidiaries to non-Swiss affiliates).

In the context of syndicated credit financing transactions, it must be ensured that no Swiss Federal withholding tax will be incurred, as this would simply not be acceptable to lenders, even in case the Swiss Federal withholding tax could be recovered at some later point. In order to prevent Swiss Federal withholding tax from being imposed on credit financing transactions (in contrast to bonds triggering such tax anyway), credit facility agreements entered into by a Swiss borrower, or a non-Swiss borrower under a guarantee from a Swiss parent company, must contractually restrict free transferability and syndication by invoking the so-called "10/20 non-bank rules" and stating that:

- the lenders must ensure that while the loan in question is outstanding, no assignments, transfers or relevant sub-participations of loan tranches will be made, as a result of which the number of ten non-bank lenders would be exceeded; and
- the borrower must ensure that it will at no time have more than 20 non-bank lenders under any of its borrowings (in both cases generally disregarding any affiliated lenders).

As a result, credit financing transactions that must be broadly syndicated outside the banking market, because the banking market would not absorb such transaction, (such as TLB transactions) cannot provide for a Swiss borrower and it is necessary to structure around this.

Fundamental changes envisaged by Swiss Federal Council

On 3 April 2020, the Swiss Federal Council initiated a consultation process (*Vernehmlassung*) regarding a planned reform of the Swiss Federal withholding tax. The reform originally intended replacing the current debtor-based regime applicable to interest payments with a paying agent-based regime for Swiss Federal withholding tax. Under such a paying agent-based regime, if introduced, a Swiss paying agent would need to levy and pay Swiss Federal withholding tax on interest payments on bonds (or loans), if the beneficiary were an individual resident in Switzerland. As a consequence of the consultation process, the Swiss Federal Council, on 11 September 2020, resolved on an abolishment of Swiss withholding tax on interest payments (with the exception of interest payments on domestic bank accounts and deposits to Swiss resident individuals), without substitution, and it submitted a corresponding legislative project to the parliamentary process on 14 April 2021.

Comment

The abolition of Swiss withholding tax on bonds and other collective debt financings should significantly strengthen Switzerland's position as financial market and treasury centre. All types of financing and refinancing activity in Switzerland (eg, raising of capital via bond issuances, crowdfunding platforms, ABS structures and other capital market transactions) will be facilitated. In the context of syndicated credit financing transactions, structuring will become more straight-forward as Swiss borrower structures would no longer have to address the "10/20 non-bank rules" and broader syndication outside the banking market would no longer be restricted.

It is unlikely that this fundamental change of the Swiss withholding tax regime will enter into force before 1 January 2024.

SWITZERLAND TRENDS AND DEVELOPMENTS

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Walder Wyss Ltd is a leading law firm in Switzerland with around 240 legal experts across offices in Zurich, Basel, Berne, Geneva, Lausanne and Lugano, including a team of 14 partners and additional 30 legal experts in the area of banking and finance. Walder Wyss advises all major Swiss and international banks as well as borrowers in domestic and cross-border lending

transactions. Further, Walder Wyss advises a considerable number of private equity investors in leveraged acquisition finance transactions. Another core competence of the team is its knowledge of and experience in refinancing transactions of credit portfolios through various public and private structures.

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