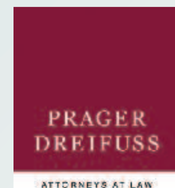
BANKING AND FINANCE

A guide to cross-border financing in Switzerland

Daniel Hayek and **Mark Meili** of **Prager Dreifuss** look at the rules, practicalities and latest developments in what continues to be a friendly environment for cross-border financing



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Switzerland is home to approximately 250 banks with an aggregate balance sheet of about CHF3.23 trillion ($3.25 trillion). Consequently, the Swiss cross-border financing market is mature and well-developed. Local banks such as Credit Suisse, UBS and the Zurich Cantonal Bank (ZKB) are the dominant lenders when it comes to cross-border financing, but international banks are also active in the Swiss market. This is because the headquarters of large international groups are located in Switzerland and also because borrowers frequently have Swiss affiliates that grant security.

Since the global financial crisis, banks in Switzerland have become stricter with regard to providing loans to companies. This trend is reinforced by Basel III legislation, which requires banks to hold more equity. Notably, it is becoming harder for small- and mid-sized companies that do not have an investment grade rating to refinance and renegotiate existing debt structures. As a result, many companies are turning to alternative lenders such as funds, pension funds, insurance companies and family offices. These lenders are less conservative than banks and are willing to take more risk. They can often be the solution for troubled companies and can help them to meet their financing needs.

Over the last decade, the ratio of Swiss bank non-performing loans (NPLs) to total gross loans has continuously fallen from 1.3% in 2005 to 0.6% in 2017, which is low in comparison to other jurisdictions and marks an all-time low for Switzerland. Consequently, NPLs are not a very topical issue. A reason for this low ratio may be that NPLs suggest that obligors are facing liquidity problems. A liquidity problem is a major issue for Swiss directors. The board of a Swiss obligor has to convene an extraordinary shareholder's meeting and propose restructuring measures if half of the company's share capital and legal reserves are no longer covered by its assets. In the event that the balance sheet of a Swiss obligor shows negative equity, the board of directors must notify the court. This usually leads to bankruptcy. If the board fails to observe its obligations, the individual directors may incur personal liability. It goes without saying that the board will try to find

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a commercial solution with the existing lenders or try to raise additional capital from alternative sources to avoid such a situation.

Switzerland provides the legal certainty to resolve any disputes relating to large-scale financial transactions. However, borrowers and lenders tend to find amicable solutions rather than resorting to litigation.

As regards trends in the market, Brexit may have a profound impact on the mechanics of cross-border financing. In particular, it seems that cross-border financing transactions in Europe are no longer solely managed by UK law firms. Local law firms across other European jurisdictions have become more powerful and sometimes take the lead in such transactions. Apart from this, the market has been rather steady over the last twelve months.

Financing structures

Recent notable transactions in the market include a multi-billion euro financing of a large-scale infrastructure project. The most interesting aspect of this transaction is that the lenders are European energy companies that do not have a banking licence. At present, there are no bank lenders involved, even though they may provide financing at a later stage of the project.

This raises some difficult questions in relation to the '10/20 Non-Bank Rule', which limits the number of potential non-bank lenders in a financing transaction (further details below). Finding a solution to the allocation of 'slots' for lenders that do not have a banking licence, thereby allowing them to provide mezzanine, bridge or funding gap capital, as well as to the transfer of loan shares to non-banks, is challenging. The composition of the lenders made this transaction quite unique. We do not expect that its structure will influence the Swiss market standard.

Syndicated secured loan facilities are probably the most frequent type of cross-border financing transaction in the market and it appears that this will not change in the near future.

Legislation and policy

There is no specific legislation and there are no specific regulatory bodies that exclusively or predominantly govern cross-border financing in Switzerland. However, it goes without saying that the Swiss Financial Market Supervisory Authority (FINMA) is relevant when it comes to the regulation of domestic (bank) lenders and that the Swiss Federal Tax Administration (SFTA) is relevant in relation to ancillary tax issues.

Swiss headquartered groups looking to raise capital via the international debt capital or bank debt markets may face Swiss withholding tax (WHT) if the issuer or borrower is a non-Swiss group member and where the structure requires guarantee support from the Swiss parent company. If there is backflow to Switzerland, a 35% WHT rate applies on the interest payments, unless the maximum backflow is capped at the equity amount of the non-Swiss issuer. On February 5 2019, the SFTA published an important clarification that introduced two exceptions to the backflow rule, which may also be combined.

Under the equity exception, it is now possible for a non-Swiss issuer with a parent guarantee from its Swiss headquarters to grant a loan back to the Swiss company sourced from the funds raised on the international capital market, whereby the up-stream loan

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will not exceed the aggregate equity of all non-Swiss subsidiaries. In case the shareholding is less than 100% in the non-Swiss subsidiary, the equity amount is reduced accordingly. Under the intragroup funding exception, it is now possible for a non-Swiss issuer, which holds a parent guarantee from the Swiss headquarters, to grant a loan back to the Swiss company sourced from the funds raised on the international capital market whereby the up-stream loan shall not exceed the aggregate amount of all intragroup loans granted by Swiss group members to non-Swiss group companies.

The SFTA requires an upfront tax ruling if a Swiss headquartered group wants to benefit from the new exceptions. The new regime is likely to increase the ability of Swiss groups to raise funds outside Switzerland and to use such funds in Switzerland.

Meanwhile, the abolishment of the 10/20 Non-Bank Rule has been widely discussed, because it could considerably improve the appeal of directly lending to Swiss borrowers. A corresponding consultation draft bill to change the Swiss law on WHT on interest income is expected for the end of 2019. It is envisaged that interest paid to investors outside of Switzerland will no longer be subject to Swiss WHT. For the 10/20 Non-Bank Rule, this means that re-characterising a loan as a bond (which is dependent on the number of creditors involved that are not banks) will no longer have any implications for Swiss WHT on interest.

In a nutshell, the 10/20 Non-Bank Rule states that interest payments are subject to 35% WHT rate, if the number of lenders without a banking licence exceeds 10, under a single debt instrument, or 20, under all debt instruments of the Swiss borrower taken together. Under certain circumstances, interest payments guaranteed by a Swiss guarantor may be subject to WHT as well. The limitation of syndication to non-bank lenders due to the 10/20 Non-Bank Rule is a viable solution to avoid or mitigate the consequences of this rule. However, such an approach may not be satisfying in larger syndicated finance transactions or if the involvement of lenders without banking licence is a necessity. In such cases, funds are often raised by a foreign parent company, with the Swiss entity acting solely as guarantor and security provider.

If this structure is properly planned and implemented, the applicable upstream and cross-stream limitations (see below) could be reduced to minimum; but it would be preferable if the lenders had unlimited claims against the Swiss entity and the transfer of loan shares to non-banks was not restricted. Therefore, the abolishment of the 10/20 Non-Bank Rule would be most welcomed by borrowers and lenders. As a positive side effect, the volume of loans made available to Swiss borrowers could increase substantially.

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Market norms

As mentioned above, the 10/20 Non-Bank Rule and the applicable up- and cross-stream limitations on guarantees (see below) may have a significant impact on the structuring of a deal. This is frequently underestimated by foreign lenders who are not familiar with the Swiss market. Indeed, the most frequently asked questions about the market concern the potential structure of the transaction in the light of the 10/20 Non-Bank Rule, the applicable up- and cross-stream limitations and the resulting tax consequences. Not all foreign lenders are aware of the significance of these issues.

To a lesser extent, lenders also want to know which asset classes can be taken as security and what documentation or formalities are required to create, perfect and maintain such security.

As for the security regime, security can be taken over all classes of assets a lender would usually expect, such as shares, bank accounts, receivables, insurance policies, real property and intellectual property.

In order to perfect and maintain a pledge over shares (or other movable objects), the security trustee needs to be in physical possession of the pledged movable objects during the security period (*Faustpfandprinzip*). As a consequence of this requirement, security over plants, machinery, equipment or inventory is possible, but is usually not taken. There are also some limitations to security taken over real estate that serves primarily as living accommodation, and there are certain formalities that must be observed. However, the quality and value of the security is usually worth the extra effort.

In principle, floating charges are not available in Switzerland. However, there is the option to grant security over a value quota of an intermediated securities account. Therefore, it is possible to create Swiss security over intermediated securities that is, to a certain extent, similar to a floating charge. It should be noted that there are several ways to create security interest over intermediated securities.

Solutions exist to avoid or at least mitigate the impact of any the particular demands that the Swiss market places on lenders and borrowers. The best approach for a lender that is not familiar with the Swiss jurisdiction is to engage a specialised Swiss law firm before agreeing to a financing structure that could be either difficult or impossible to implement.

Practical considerations

A key consideration for most cross-border financings should be downstream, upstream and cross-stream guarantees. In Switzerland, downstream guarantees are not subject to restrictions or limitations, but upstream and cross-stream guarantee payments are considered to be constructive dividends and are, as a result, limited to the profits and reserves freely available for distribution in the guarantor's balance sheet. Consequently, the respective rules for distribution of dividends must be observed. This includes the preparation of an up-to-date balance sheet by the guarantor and the approval of the resulting distribution by a shareholders' meeting.

In order to maximise the assets available for distribution, the finance documents should contain Swiss guarantor limitation language to that effect. It is also standard to combine a guarantee with a pledge over the shares in the Swiss guarantor.

It should also be noted that the proceeds from upstream and cross-stream guarantees are subject to a 35% WHT. In recent years, it has become standard practice for the SFTA to request that any Swiss company providing a

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guarantee to its parent company receive appropriate remuneration for the guarantee: a guarantee fee.

In the context of a bankruptcy or restructuring, the enforceability of any contract may be limited under the rules of the Swiss Debt Enforcement and Bankruptcy Act. In particular, the following transactions may be fully or partially voidable:

- Transactions carried out during the year prior to the bankruptcy or insolvency decree, in which the Swiss security grantor accepted to receive no consideration at all or a consideration out of proportion to its own performance.
- Certain financially inadequate transactions, if carried out during the year prior to the bankruptcy or insolvency decree and if the Swiss security grantor was at the time of the transaction already over-indebted. However, the transaction is not voided if the recipient proves to have been unaware of the security grantor's over-indebtedness.
- All transactions which the Swiss security grantor carried out during the five years prior to the bankruptcy or insolvency decree with the apparent intention of disadvantaging its creditors, or of favouring certain creditors to the disadvantage of others.

Another major insolvency related issue that should be addressed in the finance documents is the allocation of proceeds between the different classes of lenders. Frequently, there is a foreign law-governed intercreditor agreement that provides for a certain waterfall, but that does not necessarily take into account Swiss insolvency law. In particular, subordination of claims can lead to issues and delays in relation to the enforcement of security in Swiss insolvency proceedings, if it has not been properly addressed in the intercreditor agreement, the security documents and other ancillary documentation.

As for other practical considerations, there are no foreign debt quotas which would have to be observed in connection with a cross-border financing. There are also no rules that would require any specific monitoring of offshore financing to domestic entities, subject to the applicable money laundering legislation and sanction regimes.

Looking ahead

The 10/20 Non-Bank Rule has been identified as an obstacle for cross-border financings connected to Switzerland. The rule may soon be abolished, or at least be replaced with a more market friendly rule. However, this will likely take more than 12 months.

Further, the financial market could benefit from the increased presence of non-traditional creditors, such as hedge funds. These investors are also able to provide liquidity to companies in trouble that may otherwise be constrained.