The growth of sustainable bonds in Switzerland

Oliver Widmer and **Manu Ferro** of **Pestalozzi** discuss how the existing Swiss legal framework provides sufficient legal basis to issue, list and trade sustainable bonds

The Swiss market for sustainable bonds, although still relatively small, is steadily growing. This is particularly true for green bonds, which currently represent 1.2% of the total Swiss capital market and comprise approximately CHF5 billion in green bonds outstanding.

In November 2021, the Swiss Federal Council, closely following the robust growth of Switzerland's green bond market, decided to lay foundations to enable the issuance of green confederation bonds. The framework, specifying the conditions, criteria and process for the issuance of green bonds will be submitted to the Federal Council by the end of 2022. With this initiative, the Federal Council also hopes to encourage the private sector to issue green bonds.

A look at the bonds listed on the SIX Swiss Exchange shows that sponsors and issuers of the private sector are already active in this area and have started to issue and list sustainable bonds. The focus on green bonds is also evident here: As of today, a total of 64 green bonds are listed on the SIX Swiss Exchange. In comparison, the number of other sustainable bonds is still small.

Currently, SIX Swiss exchange reports five sustainability-linked bonds as well as one social and one sustainable bond. The issuers of these bonds are mainly banks and insurers but also include the cantons of Basel Stadt and Geneva.

This article provides an overview on the currently used terminology for sustainable bonds and discusses applicable legal basis in Switzerland for the issuance, listing and trading of sustainable bonds.

Definition of a sustainable bond

In Switzerland, there is currently no legal definition of a sustainable bond. Hence, issuers and other actors have to rely on standards adopted by self-regulatory organisations or similar. SIX Swiss Exchange categorises sustainable bonds

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according to the principles and guidelines published by the International Capital Market Association (ICMA) and differentiates between green bonds, social bonds, sustainability bonds and sustainability-linked bonds. Special flags for these types of bonds were introduced by SIX Swiss Exchange.

Green bonds are any type of bond instrument where the proceeds (or equivalent amount) will be dedicated to green projects.

Likewise, social bonds are any type of bond instrument where the proceeds (or equivalent amount) will be dedicated to social projects and the proceeds of sustainability bonds are dedicated to a combination of both green and social projects.

The characteristics of sustainability-linked bonds depends on the achievement of predefined sustainable objectives which are measured through predefined 'Key Performance Indicators' and assessed against predefined 'Sustainability Performance Targets'.

Each category of bonds of the SIX Swiss Exchange must be aligned with the relevant ICMA principle or guideline. In addition, to be eligible for the relevant flagging of SIX Swiss Exchange, green bonds must be included in the Green Bond Database by the Climate Bonds Initiative. ICMA's principles and guidelines for each of these categories have become the leading framework globally for the issuance of sustainable bonds and consist of the Green Bond Principles (GBP), Social Bond Principles (SBP), Sustainability Bond Guidelines (SBG) and Sustainability-Linked Bond Principles (SLBP).

The GBP and SBP both consist of four core components which have to be met by any green, social or sustainability bond:

- Use of proceeds: The cornerstone of a sustainable bond is the utilization of the proceeds of the bond for eligible green projects (green bond), social projects (social bond) or a combination of the two (sustainability bonds). The GBP and SBP provide for some examples for green and social projects. Green projects are essentially projects that contribute to environmental objectives such as climate change mitigation and adaption, natural resource or biodiversity conservation as well as pollution prevention and control. Social projects directly aim to address or mitigate a specific social issue or seek to achieve positive social outcomes such as, for example, access to essential services, affordable housing or affordable basic infrastructure.
- Process for project evaluation and selection: The issuer of the bond has to clearly communicate to investors the green, social or sustainable objectives of the relevant project as well as the criteria used to determine these projects. Any complimentary information on processes relating to the identification and management of the risk associated with these projects should be shared with investors as well.
- Management of proceeds: The issuer should track the net proceeds of the relevant bond in an appropriate manner (i.e. by crediting it to a sub-account or similar) and periodically adjust to match allocations to the relevant eligible green or social project.
- Reporting: The annual report should contain information on the use of proceeds and include a list of the projects to which these proceeds have been allocated. Information on material development has to be made available on a timely basis.

With regard to sustainability-linked bonds, the five core components of the SLBP must be met by any sustainability-linked bond:

- Key Performance Indicators (KPI): The objectives pursued with the sustainability-linked bond are measured through predefined KPIs. The selected KPIs should be relevant to the issuers business and strategy, measurable, externally verifiable and able to be benchmarked.
- Sustainability Performance Targets (SPT): The calibration of SPT expresses the level of ambition of the issuer. The target setting should be based on a combination of benchmarking approaches such as the issuer's own performance over time, the issuer's peers and reference to the science.
- Bond characteristics: The bond needs to include a financial and/or structural impact involving trigger events (e.g. a variation of the coupon) as the bond's characteristics vary depending on whether the selected KPIs reach the predefined SPTs or not.

> ***"The framework, specifying the conditions, criteria and process for the issuance of green bonds will be submitted to the Federal Council by the end of 2022"***

- Reporting: Issuers should report regularly, at least annually, on the performance of the selected KPIs and provide a verification assurance report relative to the SPT outlining the performance as well as any information enabling investors to monitor the level of ambition of the SPTs.
- Verification: Independent, external and appropriate verification by an external reviewer (such as an auditor) should be sought at least one a year of the performance level against each SPT for each KPI.

With regard to the type of bond required, any type of bond instrument can serve as basis for a sustainable bond as long as the relevant criteria under the ICMA's principles and guidelines is fulfilled. ICMA lists currently four types of bonds (standard use of proceeds bonds, revenue bonds, project bonds and securitized bonds) but acknowledges that additional types may emerge as the market develops.

Swiss legal and regulatory framework

General

So far, Switzerland does not have specific legal or regulatory framework for sustainable financial products and services. Therefore, the existing financial market regulation and general Swiss law also applies to the issuance, listing and trading of sustainable bonds. The most important laws or status currently existing and applicable to the issuance and trading of sustainable bonds is the Financial Services Act (FinSA) and the related ordinance.

In addition, the Swiss supervisory authority and 'regulator', the Swiss Financial Market Supervisory Authority (FINMA), may give guidance and adopt practical rules and circulars. FINMA has particularly been active in the area of transparency and disclosure obligations with regard to climate change-related risks in the financial system. With regard to sustainable financial products and services, FINMA's focus lies in the prevention of greenwashing, i.e. the misleading investors about sustainable characteristics of financial products and services.

Issuer (primary market)

From the issuer's perspective, the most important aspect to observe when issuing sustainable bonds are the disclosure obligations for the prospectus and other offering materials. The general provisions of FinSA relating to the prospectus (and other offering materials) are applicable to the issuance of sustainable bonds.

According to these provisions, any person in Switzerland issuing securities, such as sustainable bonds, must publish a prospectus, if the bond shall be publicly offered or admitted to trading on a trading venue in Switzerland. If a (sustainable) bond is offered to retail clients, the issuer must provide a key information document (KID) (in addition to the prospectus).

The FinSA provides for certain exemptions to publish a prospectus or KID. The prospect (and KID, if applicable) needs to contain the essential information on the issuer, the securities (specifically the associated rights, obligations and risks for investors) and the offer, including the estimated net proceeds of the issue.

The KID should also contain information on the risk/return profile and any information on the authorisation and approval associated with it. The prospectus will be checked by a reviewing body on its completeness, coherence and comprehensibility. Information in the prospectus or KID that is inaccurate, misleading or in violation of statutory requirements may lead to liability of the issuer towards the acquirer. In addition, FinSA contains criminal provisions for any person who willfully provides false information or withholds material facts in the prospectus or KID.

A look at sustainable (especially green) bonds already issued shows that the main risk disclosed in connection with sustainable bonds is the lack of a clear definition on precise attributes for a particular product to constitute a green, sustainable, environmental or similar labelled project.

Even if a bond is designated as green, social or sustainable or listed in a similar labelled segment on a stock exchange, there is uncertainty whether such designation or segment will be maintained throughout the lifecycle of the bond, especially because a consensus of or clear definition on these terms may change over time.

A withdrawal of the designation or label may adversely affect the value of the bond. In addition, providers of second party opinions or similar evaluations are not subject to specific regulatory or other regime or oversight which makes it harder for the bondholders to have recourse against any second party opinion provider. This is particularly problematic if the second party opinion has a material adverse effect on the value of the sustainable bond.

From the issuer's point of view, a coherent and uniform definition of the terms "green", "social" and "sustainable" in relation to bonds would be beneficial to mitigate the risks associated with sustainable bonds.

Switzerland does not have a classification system comparable to the EU Taxonomy (or other) and so far, the legislator does not deem it necessary or appropriate to establish such classification system or taxonomy on a legal or regulatory level. However, FINMA and the Federal Council as well as private actors are closely following the international taxonomy efforts. Also, self-regulatory organisations (such as the Swiss Sustainable Finance Organisation (SSF)) and other private actors (for example, the Swiss Bankers Association (SBA)) as well as international associations like ICMA are setting standards and may provide some guidance.

Exchange

From the exchange's point of view, the listing of a sustainable bond is generally not different than of 'normal' bonds. The requirements for a listing on the SIX Swiss Exchange for sustainable bonds are subject to the "normal" listing rules of SIX Swiss Exchange (and any additional directives and similar).

Noteworthy in this regard is the special flagging system introduced by SIX Swiss Exchange to label sustainable bonds if the requirements under ICMA's principles and guidelines are met and, in case of green bonds, if the bond is included in the Green Bond Database by the Climate Bonds Initiative.

Financial Service Providers (Secondary Market)

For the provision of financial services with or relating to sustainable bonds, the relevant provisions of FinSA apply. A special focus lies on the prevention of greenwashing risks.

A financial service provider under Swiss law is any person who provides a financial service on a commercial basis in Switzerland or for clients in Switzerland. Financial services are, apart from portfolio management and investment advice with regard to financial instruments, the acquisition or disposal of financial instruments as well as the receipt and transmission of orders in relation to financial instruments.

Bonds qualify as financial instruments (and usually also as securities). Hence, the trading for clients of a commercial basis of sustainable bonds (or provision of other financial services in connection with sustainable bonds) may be subject to regulatory provisions under FinSA.

Financial service providers are subject to certain code of conduct obligations under FinSA if the financial service is provided for retail clients or professional clients. The code of conduct obligations do not apply to transactions with institutional clients. In addition, the code of conduct obligations depend on the specific financial service provided.

With regard to the provision of financial services provided in connection with sustainable bonds, the duty to provide information is of particular relevance (although professional clients may expressly release the financial service provider from such duty). Financial service providers must, among other things, provide their clients with information on the financial instruments they offer.

With regard to the financial instrument (for example, sustainable bonds), the information that needs to be provided relates firstly to the specific characteristics and the expected return on the financial product. Clients must further be made aware of the risks associated with the acquisition, sale or holding of the financial instrument. In case this information is included in the KID or the prospectus, the information may be provided by making the corresponding document available (and, with regard to the prospectus, the financial service provider needs to make sure that the client understands it).

The willful provision of false information or withholding of material facts under the duty to provide information may lead to criminal liability of the financial service provider.

The practical difficulties when providing financial services with sustainable bonds are comparable to those of the issuance of a sustainable bond. The absence of a uniform and binding definition of green, social and sustainable bonds (or financial service) complicates the assessment of compliance with the information duty. However, as the duty to provide information only applies to retail clients and professional clients who did not waive such obligation, it is questionable whether these considerations have much practical implications.

Concluding thoughts and outlook

In principle, the existing Swiss legal framework provides sufficient legal basis to issue, list and trade sustainable bonds. However, there seems to be some uncertainty with regard to risk disclosure obligations and information duties due to a lack of consistent and standardised definitions for green, social and sustainable bonds. Whether this issue will be resolved on a legal or regulatory level remains to be seen.

FINMA as regulator currently has two main focuses in connection with sustainable finance in general: The precise identification and disclosure of climate change-related risks and the prevention of greenwashing. The implementation of a coherent terminology is, at least to some extent, connected to the risk disclosure.

With regard to greenwashing risks, in addition to the practical hurdles due to the lack of a coherent definition of sustainable bonds, FINMA's scope of action for efficient greenwashing prevention and avoidance is limited anyway, especially for not prudentially supervised financial market participants. For example, there is a lack of specific sustainability-related transparency obligations and effective supervisory foundations for action at the point of sale.

From the legislator's view, no need for regulation of taxonomy is deemed necessary at the moment but the developments in the industry and internationally, namely in the EU, will be closely monitored. This is also the view from (part of) the industry.