

Spotlight 06/25



LOMBARD LOANS IN THE CRISIS

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Wenger Vieli Ltd.

Dufourstr. 56

P.O. Box

8034 Zurich

—

Metallstr. 9

P.O. Box

6302 Zug

—

+41 58 958 58 58

spotlight@

wengervieli.ch

When financial markets experience turbulence, such as the recent volatility caused by President Trump's tariffs, investors can be negatively impacted. This is particularly true for those financing their investments with Lombard loans. In the event of a market crash, they should anticipate margin calls from their banks, requiring additional contributions. The following discussion addresses several legally relevant aspects.

Functionality and Risks of Lombard Loans

Lombard loans are a common method of obtaining liquidity. They provide a customer with a bank loan to execute financial transactions, secured by pledged assets—typically financial instruments held in a custody account or other readily disposable assets. The term "Lombard loan" originates from Lombardy, northern Italy, where such loans secured by pledged assets were common as early as the Middle Ages.

«THE RISK OF A LOMBARD LOAN LIES PRIMARILY IN LEVERAGE, AMPLIFYING BOTH POTENTIAL RETURNS AND THE RISK OF LOSS.»

The credit limit for a Lombard loan depends on the value of the pledged financial instruments. Assets are lent up to a percentage of their market value (the loan-to-value ratio). This ratio is determined by the financial institution based on the type, currency, quality, volatility, and tradability of the instruments.

Bank loan agreements typically stipulate that the bank can demand additional contributions if the pledged assets decline in value. This demand, known as a margin call, requires the customer to provide additional cash or assets within a short timeframe (often a few days).

A margin call occurs when the value of the margin account falls below the bank's required collateral level. Unless otherwise contractually agreed, the timeframe for providing additional contributions is at the bank's discretion and is not based on the customer's ability to comply but rather on the prevailing market conditions.

The primary risk of a Lombard loan is leverage, which magnifies both potential returns and losses. If a customer fails to meet their obligation to provide additional contributions, the pledged assets are liquidated, regardless of unfavorable market conditions. The customer has no right to wait for a price recovery. Liquidation during a price slump can result in significant losses. If the proceeds from liquidation are insufficient to cover the loan, the customer loses the pledged assets and remains liable for the outstanding balance.

The increased risks associated with Lombard loans impose specific obligations on financial service providers, briefly outlined below.

Information Obligations of the Financial Service Provider

According to the Federal Supreme Court, financial service providers have an increased duty to disclose the risks of investment transactions when the customer is leveraging borrowed funds. This applies to Lombard loans, which are considered financial services under the Financial Services Act (FinSA). Therefore, the conduct and information obligations under FinSA apply. The financial service provider must inform the customer about the loan's characteristics and function (including leverage and margin calls), as well as the customer's main rights and obligations.

If the Lombard loan is part of investment advice or asset management, the financial service provider must conduct an appropriateness or suitability test and may also have a monitoring obligation.

«LIQUIDATION OF PLEDGED ASSETS DURING A PRICE DECLINE CAN RESULT IN SIGNIFICANT LOSSES FOR THE CUSTOMER.»

Realization Rights of the Financial Service Provider

While not explicitly mandated by law, the pledgee and pledgor may agree that the pledgee can liquidate the collateral. According to the Federal Supreme Court, the pledgee must provide timely notice of the liquidation date to the pledgor and compensate the pledgor for any losses resulting from insufficient proceeds attributable to the pledgee's actions.

These principles apply to Lombard loans. Bank loan agreements typically grant the bank the right to liquidate pledged assets if the customer fails to meet a margin call. The liquidation notice is usually included with the margin call.

Whether a margin call is required even without contractual agreement is unclear.

However, if a margin call is contractually agreed upon, liquidation without notice constitutes a breach of contract.

For intermediated securities (electronically recorded securities) used as collateral, the Intermediated Securities Act governs the realization rights and procedures. Legal notice of liquidation is generally required, often included with the margin call.

Liability Risks

Despite the legal basis for the realization right in Lombard loans, financial service providers face liability risks. Liability can arise from breaches of the duty to provide information, such as failing to disclose the increased risks of financing investments with Lombard loans or not considering the increased risk of loss during a suitability test.

The Federal Supreme Court has affirmed liability for damages in cases where banks liquidated pledged assets without a valid margin call. The customer must prove they would have met the margin call obligation. Liability can also arise if the bank fails to issue a timely margin call, increasing losses from collateral liquidation due to further price declines. Finally, liability is possible if assets are liquidated below market value or if conflicts of interest exist.

«DESPITE THE LEGAL BASIS FOR THE REALIZATION RIGHT IN LOMBARD LOANS, FINANCIAL SERVICE PROVIDERS FACE LIABILITY RISKS.»

In all cases, comprehensive written documentation of communication between the financial service provider and the customer is crucial, as verbal agreements in crisis situations can be difficult to prove.

Keyfacts

- 01 A Lombard loan provides a customer with a bank loan for financial transactions, secured by pledged assets (financial instruments or other readily disposable assets).
- 02 The primary risk of a Lombard loan is leverage, amplifying both potential returns and losses.
- 03 Despite the legal basis for liquidation rights, financial service providers face liability risks.



Nicolas Bracher

Partner

n.bracher@wengervieli.ch

+41 58 958 53 23



Meltem Stuedler

Senior Associate

m.stuedler@wengervieli.ch

+41 58 958 53 86

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