Insights Into Today's Real Estate Market - A Focus on Switzerland

Basten, Christoph ; Füss, Roland ; Häfliger, Petra S ; Küng, Lorenz ; Salzmann, Daniel ; Schläpfer, Jörg

Abstract: Real estate is at the confluence of several major transformations: higher inflation, higher interest rates, and increasing ESG risks. In this Roundup, experts from academia, industry, and regulation discuss how investors and households navigate new difficult tradeoffs in the Swiss context. Will macroeconomic uncertainties affect prices and impact the financial sector? What is the proper place of real estate in an investor's portfolio? Should homeowners rethink their financing options? And will increasingly strict energy regulations impact the market?

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Swiss Finance Institute Roundups

Insights into Today's Real Estate Market—A Focus on Switzerland

Editorial

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We wish you an enjoyable read.

Prof. François Degeorge
Managing Director

Contributors

Christoph Basten
Christoph Basten is Assistant Professor of Banking at the University of Zurich. Prior to joining the University, he worked as a risk manager for the Swiss Financial Market Supervisory Authority (FINMA), where he focused on Swiss mortgage markets. He holds a PhD in Applied Economics from the European University Institute (EUI).

Roland Füss
Roland Füss is Professor of Real Estate Finance and a member of the board of the Swiss Institute for Banking and Finance and of the School of Finance at the University of St.Gallen. Prior to joining the University, he was a faculty member at the EBS Business School. He holds a PhD in Economics from the University of Freiburg in Breisgau.

Petra S. Häfliger
Petra S. Häfliger is Head of the Competence Center on the Swiss Mortgage Market at the Swiss Financial Market Supervisory Authority (FINMA), where she monitors the real estate market and analyzes various aspects of the mortgage business. Before moving to FINMA, she worked at Zürcher Kantonalbank as a Senior Quant Structurer. She holds a PhD in Physics from ETH Zurich.

Lorenz Küng
Lorenz Küng is Associate Professor of Economics at the Università della Svizzera italiana. Before joining the faculty in Lugano, he held positions at Northwestern University and served as a Research Economist at the Federal Reserve Bank of Chicago. He holds a PhD in Economics from the University of California, Berkeley.

Daniel Salzmann
Daniel Salzmann is CEO of the Luzerner Kantonalbank (LUKB) and a member of the boards of the Association of Swiss Cantonal Banks (VSKB) and of the Swiss Bankers Association (SBA). Prior to joining LUKB, he worked for UBS, Credit Suisse, and Bank Coop. He holds an Executive MBA from the Lucerne University of Applied Sciences and Arts.

Jörg Schläpfer
Jörg Schläpfer is Head of Macroeconomics at Wüest Partner, where he has analyzed the economic and regulatory environment of the real estate market since 2015. He organizes the Wüest Academy, a continuing education program for real estate knowledge, and is a guest lecturer at various universities. He holds a PhD in Economics from ETH Zurich.

July 2023 (Information as of June 2023 and data as of July 2023)

A Few Facts about the Real Estate Market

When we compare real estate to other assets, such as stocks or bonds, what are the most striking similarities and differences?

L. Küng: In many ways, real estate is the very opposite of blue-chip stocks: It is characterized by low liquidity, high transaction costs, and close to zero possibilities to short the market. Additionally, in the case of owner-occupied properties, homeowners are both investors and consumers, as the value of their house changes over time and they also benefit from it daily. In this way, homeownership increases their overall risk exposure, as homeowners are exposed both to labor market cycles and to real estate market ones; these two cycles are also highly correlated.

D. Salzmann: For the investor, a direct investment in real estate, which involves buying a specific property, is similar to acquiring a small or medium-sized enterprise (an SME); it entails active day-to-day management, which can be outsourced to a property manager. Alternatively, an indirect investment, which takes place by acquiring stock in a company that owns property, exposes you to the game and rules of the financial market; it requires trusting your fund manager to make the right decisions.

R. Füss: The investment horizon also plays an important role. Direct real estate investments are typically long-term, due to the large illiquidity and transaction costs they entail. Indirect investments show many similarities to stocks and bonds in the short term, with lower transaction costs and a large pool of renters. In the long term, indirect investments in real estate also provide a hedge against inflation and are proven to be lowly correlated with stocks and bonds or other liquid investment solutions.

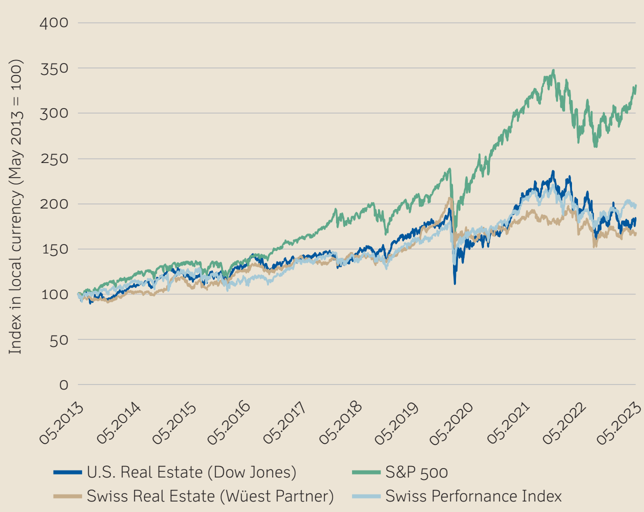
J. Schläpfer: Indirect investments, such as Real Estate Investment Trusts (REITs), are indeed an efficient way to gain exposure to the real estate market and to further diversify a financial portfolio. But investors must be aware that a given REIT typically focuses on a specific type of property, such as industrial properties or data centers, within a geographic area and is therefore not representative of the broad real estate market.

What are the usual valuation methods for estimating the price of real estate investments?

P. S. Häfliger: It depends on the type of property you are seeking to estimate. In the case of owner-occupied properties, the hedonic method represents the standard approach. It considers the different characteristics of a home, including its location, and is calibrated on recent transaction prices for similar properties. In the case of income-producing properties, the discounted cash flow method is the most appropriate. Here, expected future cash inflows from rental income and outflows due to capital expenditures are used. Note that the discount rate includes a risk premium based on the state of the property, as well as its location, and that commercial properties tend to have a larger risk premium than residential properties do.

C. Basten: The hedonic model works well for standard residential properties, where we have enough past trading observations of similar properties. By contrast, when pricing more exotic houses, a cost-based approach, which adds the value of the land and the construction costs, and subtracts amortization, is often more appropriate.

Total return for stocks and listed real estate companies



Sources: S&P Global and Wüest Partner

What different methods exist to finance real estate investments?

R. Füss: Homeowners typically have no alternative than to take a highly leveraged approach involving a mortgage, while institutional investors, who are more constrained from a regulatory perspective, tend to purchase real estate with limited external financial help. During the past 15 years, when liquidity was abundant, institutional investors gradually crowded out homeowners from the residential real estate market, due to diversification requirements and limited investment opportunities within the stock and bond markets. Another side effect of excessive liquidity has been the increasing role of financial players, in particular in the US, buying a broad spectrum of single-family homes and merging them together into a tailor-made portfolio either for the stock market or for an institutional investor.

D. Salzmann: If bank financing is required, then there is no significant difference whether the purchase is made by a homeowner or an investor; the underlying instrument remains a mortgage. But nuances are found in the various requirements for loan-to-value ratios, as well as in the valuation methods applied. In the case of sophisticated investors, we can envision a financing facility which includes a borrowing base as well as lines of credit.

What are the main limitations regarding data on real estate investments?

L. Küng: The low number of transactions is clearly the key concern. Compound this with the fact that such data are typically compiled only a few times per year, that just about every property is different, that their characteristics change over time (due either to improvements or to lack of maintenance), and that the tax system can vary significantly from one location to another, and you end up with a very fuzzy picture of the market. Data collection has been improving in many countries, including Switzerland, but it will still take many years before we can access data in a somewhat similar way to what can be done in the US.

J. Schläpfer: There is no doubt that the US has a data advantage. As Switzerland is a small country, the absolute number of transactions is remarkably low. Only a few hundred direct income-generating transactions take place each year, which makes generating a price index a difficult, if fascinating, task. Another limitation we face is that, although data collection has significantly improved over the past 20 years, the real estate market in Switzerland has been on an upward trend during this period. Knowing how to calibrate a model for a downward market, and being able to isolate data outliers, is a challenge. Interestingly, alternative data, such as online postings, are becoming more and more valuable.

How different is the Swiss real estate market from that in other countries?

L. Küng: The homeownership rate is clearly the metric which stands out when we look at Switzerland, as it must be one of the lowest in the OECD. Although many factors can explain such a figure, I believe that the high level of tenant protection and the presence of market liquidity within the rental market, as well as the taxation of imputed rents for homeowners, are the key drivers. Also, Swiss financing regulations are highly stringent, which may explain why price changes over the past 20 years have been more moderate than in other countries.

C. Basten: Because of tax incentives, the ratio of household debt to disposable income in Switzerland is close to 230% – one of the highest in the OECD. To be sure, this figure reflects gross debt and not net debt, and household debt can include other types of debt than just mortgages, but this figure would be considerably higher if the homeownership rate were not about 40%, as it currently is in Switzerland, but nearer the EU average of 70%. Because of limited data availability, we do not know how debt and assets are distributed. We therefore have limited knowledge of how quickly assets would be available if needed, for example, to service or repay mortgage debt after interest rate increases.

R. Füss: The Swiss rental market is highly regulated, which translates not only into low homeownership rates, but also into considerable heterogeneity in rental prices. It is not unusual to see large apartments, rented out to the same family for decades, being priced significantly less than smaller apartments with high tenant turnover rates. Taxation is an equally interesting difference. In Switzerland, an owner-occupied home is considered an investment for which maintenance costs are tax deductible, but for which owners bear an imputed rent, which gets added to their taxable income. By contrast, in Germany the opposite occurs: Maintenance costs are not tax-deductible, and the concept of imputed rent does not exist. Over the years, these differences have created very different markets.

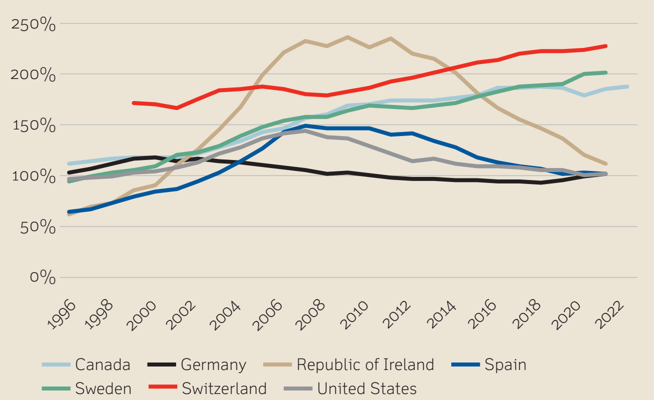
From a macroeconomic perspective, is real estate the key driver for economic activity?

J. Schläpfer: My favorite economic model shows that the demand for real estate construction is triggered by an increase in the price of existing real estate, which itself is triggered by a strong economy. In the case of Switzerland the effects are sluggish, due to the fact that only a little land remains that is zoned, but undeveloped and, of that, only a limited amount is actually available for purchase and development.

P. S. Häfliger: You could also ask: Is economic growth a key driver for real estate prices? However, real estate prices for both owner-occupied and income-producing properties are proven to have a certain correlation with economic growth. In Switzerland, residential real estate prices have been steadily increasing for more than two decades, and the mortgage volume now stands at 1.5 times the country's GDP. The real estate sector is, therefore, a key focus of FINMA's supervisory activities. Stress tests on selected banks show that considerable losses are to be expected in the banks' mortgage portfolios, should a severe real estate crisis occur. Because of contagion effects, such a situation would create enormous distress in the overall financial system. At FINMA, we recently applied machine learning algorithms, while using a high-dimensional feature space, and demonstrated that GDP, as well as real interest rates, has a strong impact on the real estate market of owner-occupied properties. It is also likely that private wealth plays an important role, but because of a too-short time series, it is not possible to provide a statistically sound answer to that question.

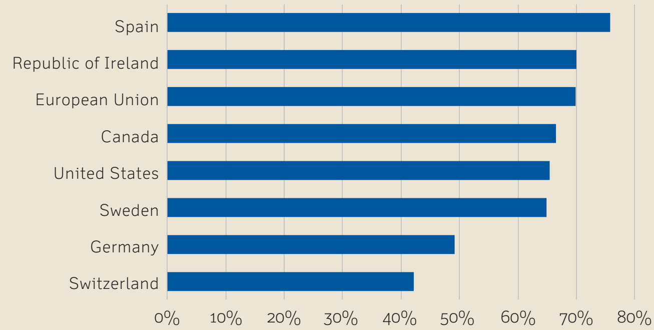
L. Küng: Data limitations, and the fact that each economic cycle is unique, make it difficult to provide a conclusive answer, but academic research shows that homeowner leverage is often the main determinant at play. If Switzerland wanted to take a more prudent stance, perhaps the amortization rules could be tweaked to further decrease the relationship between overall economic activity and the real estate market.

Total household debt, % of net disposable income



Source: Organisation for Economic Co-operation and Development

Homeownership rates (%)



Sources: Eurostat, Statistics Canada, and US Census Bureau


FOR
SALE
OR RENT
PRICE REDUCED

The Recent Past and Today's Environment

In the aftermath of the "Global Financial Crisis" of 2008, central banks worldwide significantly reduced their interest rates. How did these policies impact the real estate market?

C. Basten: In analyses of various countries since 2008, historically low interest rates appear to be a main driver of increasing real estate prices. Following the rise in interest rates since early 2022, these price increases are expected to slow down or reverse. But because of long-term fixed-rate mortgages and infrequent trading of real estate, there is a significant time lag before policy rate changes feed through to house prices.

L. Küng: While some research shows that we have been experiencing decreasing interest rates for about 100 years, what was novel in the past 15 years is the appearance of policy rates being set at, or even below, 0%. Interest rates generally still remain below the inflation rate, despite recent increases in policy rates. My perspective is that the real estate market, along with the equity market, recovered remarkably rapidly after the global financial crisis, when we consider how severe that economic crisis was and how long it took for the labor market to return to normal. It will therefore be interesting to see how the financial market and the real economy evolve over the next few years.

P. S. Häfliger: The main problem is that the recent period of negative interest rates in Switzerland has led to enhanced risk taking and to less conservative lending standards, which have increased the overall risk exposure of both homeowners and the financial market. The historically low financing costs strengthened the demand for self-occupied properties, as well as for income-producing properties, due to the lack of alternative solutions with positive return rates. This excess demand has led to an increase in the growth of prices in the Swiss residential real estate market.

D. Salzmann: There is no doubt that monetary policies, such as quantitative easing, have caused a massive increase in real estate prices. While the consequences of this trend are numerous, the most evident one is that, over the years, buy-to-let apartments have become increasingly attractive investment solutions for both private and institutional investors.

World population has increased by more than 30% – nearly two billion people – since the turn of the century, and now nearly 60% of the population lives in an urban area, versus 47% in 2000. What are the most evident elements of these shifts?

C. Basten: Demographics clearly play a role in real estate price trends. With an increase in the number of people wanting to live in cities, and a limited supply of buildings, real estate prices in urban areas are naturally bound to increase. While I see the trend toward urbanization continuing, there may also be countering trends in the years to come, such as the greater use of work-from-home arrangements or possibly the greater use of self-driving cars.

What do we know about the impact of the pandemic on the real estate market?

L. Küng: The pandemic clearly shook the residential real estate market, with an increase in demand for larger properties with extra room for a home office and a garden. But people are coming back to the city centers, as amenities play an important role. If you look at demographic flows alongside property prices and rents, you see that, around the globe, properties within large cities have remained in high demand.

What have been the most significant regulatory measures affecting the real estate market over the past couple of decades?

R. Füss: The "Stop Wall Street Landlords Act" of 2022 is an interesting case of regulators seeking to limit the presence of institutional investors within the single-family housing market. US data show that owner-occupiers, private investors, short-term institutional investors, and long-term institutional investors all behave in very different manners, based on their risk-taking profiles, within a given residential real estate market. Further results show that short-term institutional investors have outperformed the others by taking advantage of distressed properties and a globally bullish market. But in the process, they have crowded out homeowners, making such an Act useful to ensure that homeownership remains possible to a broad public.

P. S. Häfliger: The core of international credit regulations is embedded in the Basel regulations, to which each country provides its own "finish." There have been many changes from Basel I to Basel II, and we are now close to the implementation of Basel III. At the Swiss level we also have self-regulations, which are recognized and enforced as minimum standards by FINMA. The mortgage market has two sets of such self-regulations: one that covers the minimum standards when issuing a mortgage (such as loan-to-value ratios and amortization requirements), and another that covers structural requirements (such as affordability ratios) and monitors the overall lending portfolio, including "Exceptions to Policies," as well as the valuation rules. In 2013, the self-regulatory decision to explicitly require a 10% "own capital" down payment to finance real estate properties had a dampening effect on the growth of residential real estate prices. In 2020, the guidelines were tightened to limit the loan-to-value of residential income-producing properties to 75% and to introduce stricter amortization requirements. Overall, these restrictions have significantly slowed the number of potential buyers and investors with limited capital. I would like to emphasize that the goal of these measures was not to control the dynamics of the real estate market, but to reduce the vulnerability of the financial system by limiting potential losses due to too-permissive loan-to-value requirements.

D. Salzmann: With regards to financing limitations and requirements, each decade comes with its own round of constraints. In addition to the above-described self-regulatory measures, the Federal Council has the ability to activate countercyclical capital buffers based on the recommendations of the Swiss National Bank. This instrument was first activated in 2013 for the residential real estate sector, and requires banks to hold more equity when financing residential properties; it currently sits at its highest legally possible level.

J. Schläpfer: I view the 2014 update of the "Federal Act of Spatial Planning" as the most impactful regulatory move in Switzerland in the past ten years, as it makes building in new zones highly restrictive. Land supply, which was scarce already, will become even scarcer.

C. Basten: The zoning laws do indeed tend to be underestimated in the debate on the role and value of regulatory measures. Zoning laws do, of course, have a solid rationale in ensuring that constructions are built for a real purpose and not for speculation. But if used too restrictively, such laws can hinder the construction of denser living arrangements, even if these may be much more efficient and, perhaps counter-intuitively, more ecologically sound than arrangements that increase commuting traffic. With regards to countercyclical capital buffers, I would like to highlight the fact that, globally, Switzerland was the first country to apply such an instrument. My research has found that this move reduced systemic risk in the mortgage market, but had no significant effect on real estate prices.

The current inflationary environment has caused a wave of tightening reactions by central banks. How has the real estate market reacted to this?

L. Küng: While the increases in interest rates have either slowed the rise of real estate prices or pushed prices downward, depending on the region, we need to acknowledge that interest rates still remain low, particularly in real terms. Investors also need to consider what their alternatives are in today's inflationary environment.

J. Schläpfer: The increase in interest rates has clearly changed investors' behavior. For many years, excess demand translated into rising prices and a fair number of real estate transactions. Nowadays, not much is happening in the Swiss market. The strategy for many investors in Switzerland is to wait and see. Overall, price reactions have been limited, which may be due to the inflation hedge that real estate is able to provide.

Could we say that the real estate bubble is (finally) bursting?

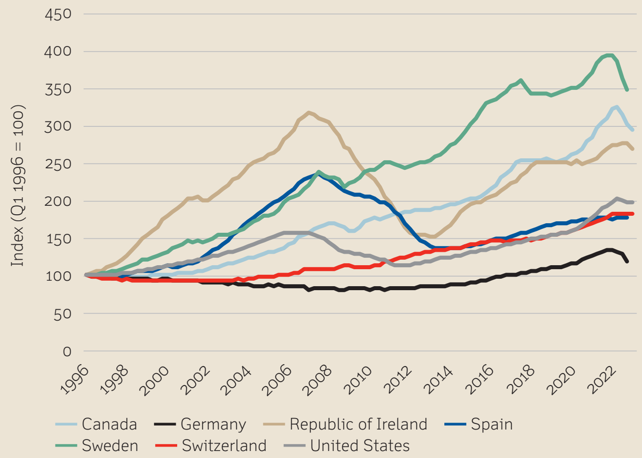
J. Schläpfer: There are clearly corrections taking place in certain countries, such as Canada, Germany, and Sweden. In Switzerland I do not anticipate a burst, simply because investors and homeowners alike have been buying to use – whether through renting or occupying the property – and not buying to resell. Such an approach clearly limits speculation.

D. Salzmann: The answer depends on which "market" we focus on, as there is actually no single real estate market, but instead a constellation of submarkets. Obviously, when one submarket plunges, it can affect the other submarkets. In Switzerland, the economic outlook remains strong, so I do not forecast any dramatic shifts.

P. S. Häfliger: Recently, the Swiss residential income-producing real estate market has been characterized by imbalances. These imbalances, between rising vacancy rates and decreasing offered rents versus increasing prices, were triggered by negative interest rates, as investors were desperately looking for investment solutions. With the rise in interest rates, these imbalances have been reduced. This does not imply that a bubble formed – and even less that one has burst. But clearly, real estate prices are at a very high level in Switzerland, and the vulnerability of the Swiss mortgage market has increased. Potential market corrections may be triggered by further increases in interest rates. The real estate sector will therefore remain a key focus of FINMA's supervisory activities.

R. Füss: From an international perspective, Swiss real estate price increases have been relatively moderate over the past 15+ years. Thus, I do not believe that there is a bubble in the Swiss housing market. If there are no dramatic changes in interest rates, demography, or other fundamentals, then we will not see any significant drop in house prices. What could cause a market shift, however, is a change in the tax system, as is currently being debated by the parliament. Suppression not only of the deductibility of mortgage-related interest and maintenance fees, but also of the taxing of imputed rents is being discussed.

Real house prices



Source: Organisation for Economic Co-operation and Development

A Few Predictions Regarding the Global Real Estate Market

Who will be most impacted by mortgage rate increases?

L. Küng: The answer to this question depends on how persistent inflation continues to be and on how the central banks assess the situation. If inflation is transitory, which seems to be the current perception, then mortgage rates should stabilize. But market expectations, as well as the decisions of foreign central banks, such as the Fed and the European Central Bank, may provide us with a few surprises.

D. Salzmann: There are several sides to this question. New buyers will clearly be the most affected by the new rates. Nonetheless, established owners will also be affected when their fixed-rate mortgages expire and they need to refinance. Finally, private investors with buy-to-let properties may be impacted, depending on their ability to adjust rents in line with inflation and interest rates.

Because of the increase in interest rates, more and more homeowners are choosing mortgages with short durations. What are the risks of doing so?

L. Küng: Taking on a short-duration mortgage increases the roll-over risk, and in finance discounts never come for free. As homeowners are heterogenous, I am reluctant to provide general advice, but they need to really understand what they are getting themselves into when they shift their mortgage from a long-term fixed contract to a short-term variable one. It may be that, sooner or later, some homeowners will have to tap into their savings to amortize part of their mortgage.

P. S. Häfliger: The flight to short-term interest rates is clearly on in the Swiss mortgage market. This creates a risky situation for homeowners as well as investors, as short-term interest rates (such as SARON) are the most volatile. This shift also has effects at the aggregate level, as exposure to interest rate risk increases the probability of default and therefore of potential losses, which ultimately increases the vulnerability of the financial system as a whole. Today's situation is different from what we have seen in the past, such as in the 1990s, however. Today's mortgage exposure is not entirely financed through short-term variable contracts, but also through long-term fixed contracts. Another key difference from the 1990s is the reduction in loan-to-value ratios, which reduces potential losses and represents considerable progress in terms of risk management.

J. Schläpfer: An interest rate surge, from 1% to 3%, such as the one recently observed in Switzerland for a ten-year mortgage, represents a massive increase in relative terms, and we see that many people are not willing to accept this change and prefer to take on extra risk to limit their immediate costs.

D. Salzmann: Betting on short-term interest rates does increase the overall risk exposure of homeowners with tight budgets. But the fact that in Switzerland we use a theoretical interest rate of 5%, when estimating the affordability ratio, does provide room for further interest rate increases. Over time, some homeowners will need to rethink their budgets.

R. Füss: Economic wisdom suggests that betting on flexible rates makes sense if you anticipate rates will go down. But rates are clearly not bound to drop any time soon. Despite all the caveats we have mentioned, many homeowners currently have significant savings, which suggests that it may take a few years before we observe the full effects of today's increase in interest rates.

Household debt has increased in line with the decrease in interest rates, but deleveraging, in the case of residential real estate, is a slow and painful process. What is the best course of action for homeowners today?

C. Basten: It is hard to say. On the one hand, it would make sense to sell stocks and bonds and to pay back mortgage debt in today's increasing interest rate environment. On the other hand, as mortgages are issued in nominal terms, it could make more sense to let inflation roll out and to pay back the debt later. It could actually make sense for banks to reduce prepayment penalties and to profit from lowering their overall exposure to the real estate market, allowing them to reinvest their capital at higher rates.

D. Salzmann: Homeowners need to crunch the numbers themselves and choose the solution that best aligns with their financial capacity and their willingness to take on risk. Personal budgeting and financial planning pay off, but only if you are disciplined. At the end of the day, an increase in savings and in debt amortization implies a reduction in spending on other items, such as groceries, holidays, or cars.

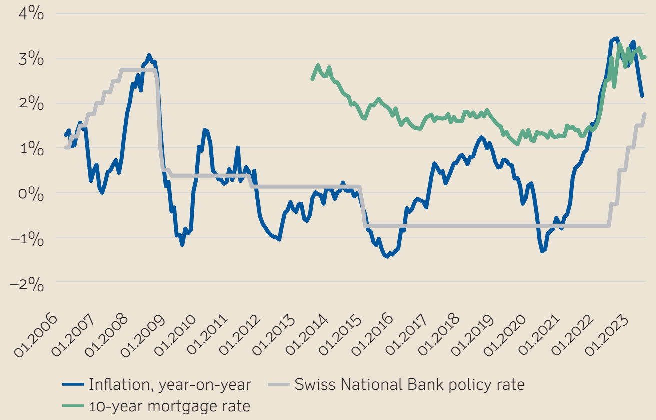
Are we going to see a repeat of 2008?

D. Salzmann: Most likely not. Risk management in banks has significantly improved since 2008, with the addition of the Basel regulations, leading to the increase in equity ratios, for example, and also providing the ability to review and update countercyclical capital buffer requirements.

R. Füss: I do not foresee any dramatic shifts at the international level, but regional banks in rural areas with negative demographic numbers should remain cautious.

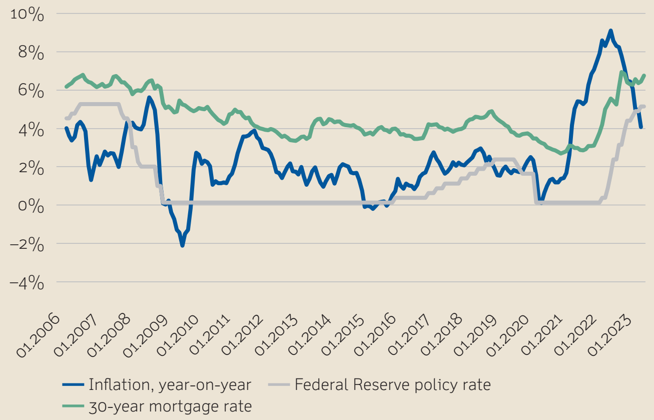
L. Küng: Homeowners today have significantly more savings on hand than in 2008, which should place us all in a better situation. But I would nonetheless remain cautious.

Inflation, central bank policy, and mortgage rates—Switzerland



Sources: Bank for International Settlements and Zürcher KantonalBank

Inflation, central bank policy, and mortgage rates—United States



Sources: Bank for International Settlements and Freddie Mac

A Few Further Predictions Regarding the Swiss Real Estate Market

Recent research suggests that, in Switzerland, renting has become financially more attractive than owning a home. Why is this the case and will such a situation prevail?

C. Basten: Whether renting or owning is "cheaper" naturally changes over time, as any mismatch between these two ways of living tends to incentivize behavior that brings them back into equilibrium. When someone is considering whether to buy or rent, I would caution them to include in the cost of owning not only the interest due, as I have seen some media do, but also the opportunity cost of capital and to account for the fact that owning implies greater exposure to changes in house prices and mortgage rates, as well as increasing the cost and complications of moving.

J. Schläpfer: We all know that making predictions about rents and valuations ten years into the future is highly complex. We must remind ourselves that buying property comes with many risks and constraints, which should be rewarded over time.

Many Swiss institutional investors have fixed quota allocations within their portfolios. With the recent drop in stock and bond prices, the proportion of real estate they hold within their portfolios has been mechanically pushed upward. What does this change mean for the real estate market? Is this an opportunity for individuals seeking to buy property?

J. Schläpfer: In general, the market has slowed down, as some institutional investors have reached, or exceeded, their quota. Anecdotally, I have observed a few sales taking place because of such quota breaches. But I do not see the effects of such sales making their way down to individuals.

P. S. Häfliger: Some investors may indeed have been forced to sell shares of real estate funds in volatile market conditions, due to such fixed quota allocations, which may explain the recent negative performance of real estate funds. Others may have sold properties simply to clean up and rebalance their portfolios. Although the media does mention such transactions occurring, statistical indices still show that prices for such properties are stable, suggesting that fire sales either are not yet taking place or are not yet impacting the market. Let us note that such transactions mainly concern multi-family homes and commercial properties and are, therefore, not of prime interest to individuals looking for a property to occupy themselves.

How will increasingly restrictive energy regulations impact the real estate market?

D. Salzmann: The question of energy efficiency has segmented the real estate market. On the one hand, private owners are largely not pressured to undertake any dramatic measures. Typically, they align themselves with the minimal legal requirements, which could eventually backfire and lead to a significant valuation discount of their properties in the future. On the other hand, an increasing number of institutional investors now need to report such metrics, which pushes them to systematically invest in efficient solutions to reduce their carbon footprint.

R. Füss: Energy efficiency is an increasingly hot topic and will broadly impact the market from rents to capitalization rates. We could envision a market where certain properties become stranded, due to the overwhelming cost of making them energy efficient. Institutional investors (and regulators) should keep an increasingly critical eye on what their real estate portfolios contain. My main concern is that the current focus is on the efficiency of new buildings. In my opinion, the focus should be on existing buildings and on finding the appropriate incentives to see them be improved, as they represent the bulk of the real estate market and of CO_2 emissions.

J. Schläpfer: It is interesting to see how the market has priced energy efficiency over the decades. Twenty or so years ago, there was a clear markup for buildings with a sustainability label, such as Minergie, making them stand out as outliers. In future years, sustainable houses will become the norm and therefore will no longer provide premiums, while inefficient buildings will come with a discount.

The loan-to-value ratio for Swiss homeowners is typically between 80% and 65%, while in many other countries, such as the US, it can run between 100% and 0%. What explains this difference? What are the pros and cons of each system?

C. Basten: Comparing loan-to-value ratios across countries can sometimes be misleading if countries use, for example, different frequencies with which they update their values. Generally, there are many benefits to having a restrictive upper loan-to-value bound, as in Switzerland: Even if the market drops, homeowners should still hold more assets than debt. Another element in favor of the Swiss system is that banks have full recourse on the borrower, which avoids strategic defaults such as those observed in the US during the subprime crisis. Nonetheless, one limitation in the Swiss system is the tax deductibility of interest payments, as this gives people the perception that holding debt is a good thing, ignoring the risks it implies.

J. Schläpfer: Both the Swiss and the US models have their pros and cons. Although changing these requirements would be difficult, I do have a critique about the Swiss system, as it typically lacks any acknowledgement that an individual's income changes over their life cycle. A young person in their 20s has the potential to see their income increase over the years, which is not so much the case of one in their late 50s.

How ready are Swiss banks for a significant market correction, in line with the 15% corrections we currently observe in Canada, Germany, and Sweden?

C. Basten: Given the regulatory caps on loan-to-value and debt-to-income ratios, as well as the incentives of the full recourse system, a 15% correction should be bearable for most banks. History suggests that markets can correct more, but if economic growth and employment remain as good as they have been so far, since the start of the policy rate increases, then the risk of a bigger correction seems limited.

R. Füss: The self-regulatory measures we apply in Switzerland, with regards to both down payments and affordability, are very conservative, so from my perspective the banks will be able to face such a shift, should it occur. Some recent buyers may need to amortize part of their debt in an expedited manner – namely by withdrawing a (further) portion of their 2nd pillar holdings. Obviously, such a move would have long-term consequences past retirement age.

D. Salzmann: The various ratios and metrics we use when providing bank financing in Switzerland are largely conservative. With regards to the affordability ratio, the use of a 5% theoretical interest rate is a prime example. For example, at the Luzerner Kantonalbank, the average mortgage to bank value ratio, a metric which is significantly more conservative than the mortgage to market value ratio, hovers a little above 50%, suggesting that there is ample headroom for a market correction. The increased amortization policies have clearly helped strengthen the Swiss banking sector. Let us also keep in mind that private owners are not forced to restructure a balance sheet, as firms are, and therefore have time to recover, as long as they can pay their financing costs.

Finally, what would be your words of caution regarding the Swiss real estate market?

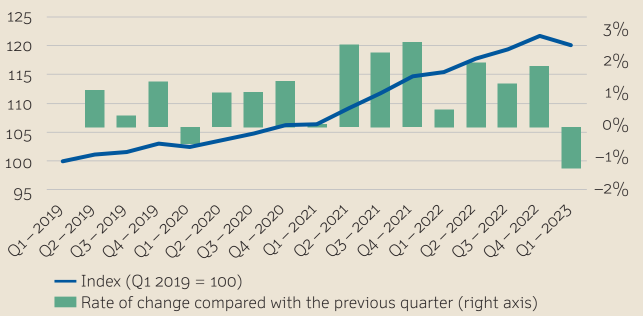
P. S. Häfliger: Homeowners and private investors need to take a long-term perspective and to acknowledge that interest rates may continue to increase over the next few years. In long-lasting periods of low interest rates, market participants, whether home buyers or bankers, tend to forget that high interest rates can even exist. When we see how interest rates are moving, the theoretical interest rate, used to compute affordability ratios, and market reality seem to be coming closer together again. Homeowners also need to be aware that their income will likely diminish when they reach retirement age, and that it might then be more difficult to service their mortgage.

C. Basten: There are many advantages to investing in real estate. Becoming a homeowner is a tangible investment and provides great consumer benefits. But it also comes with a lot of concentration risk, which is often overlooked.

R. Füss: The evolution of interest rates over the next few months will be key, as the pass-through of monetary policies on mortgage rates can happen in a non-linear way. Personally, I do not anticipate a dramatic scenario, but making such predictions is tricky, as the evolution of inflation and monetary policies remains difficult to assess.

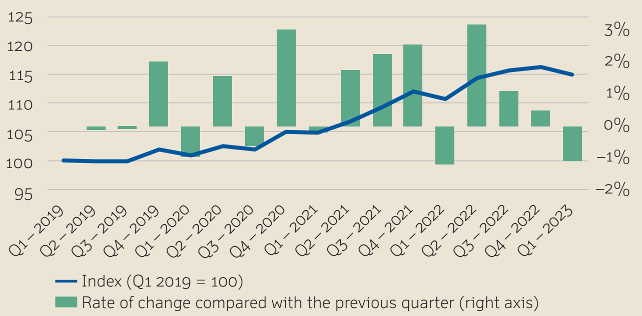
D. Salzmann: Buying property is not only a financial investment, but also one that comes with responsibilities. Homeowners need to understand what they are committing themselves to. Buying a house requires sticking to your budget and knowing how willing you are to expose yourself to risk, as only then can you knowingly structure your mortgage in terms of amounts and durations.

Single-family house prices—Switzerland



Source: Federal Statistical Office

Condominium prices—Switzerland



Source: Federal Statistical Office

Swiss Finance Institute

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Editor and contact

Dr. Cyril Pasche
Director Knowledge Exchange and Education
+41 22 379 88 25
cyril.pasche@sfi.ch

swiss:finance:institute

Walchestr. 9, CH-8006 Zurich, T +41 44 254 30 80
c/o University of Geneva, 42, Bd du Pont d'Arve, CH-1211 Geneva 4, T +41 22 379 84 71
www.sfi.ch

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