Country note: housing finance in Switzerland

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1. Overview

1.1 Characteristics and developments

The majority of Swiss households live in rented apartments or houses. Nevertheless, the **housing market** is dominated by private demand, with most owners buying to let. House prices have increased by a mere 1.5% per year over the past 20 years, so that real house prices have actually fallen over this period. Following a real estate boom at the end of the 1980s, house prices in Switzerland fell sharply during the 1990s and have only recovered moderately since 2000. Mortgage interest rates are currently at an all-time low.

While pension funds and insurance companies can also offer mortgages, commercial banks dominate the Swiss **housing finance market**. The market share of the banking sector has increased slightly over the past 10 years from 87% to 93%. The mortgage market is served by two large nationwide banks as well as state-owned cantonal banks and regional banks.[2] Mortgage lending is the main domestic activity of all three major banking groups. The housing finance market has become less concentrated over the past decade, with regional banks increasing their market share substantially.

Lenders offer a wide range of mortgage **products**. Besides the traditional variable and fixed rate contracts, combinations of the two have been introduced over the past 10 years. Despite increased product variety, however, there has been a dramatic increase in the share of simple fixed rate contracts during that time. Mortgage loans display a moderate loan-to-value ratio, arising from conservative lending practices.

Total domestic credit in Switzerland is covered by the domestic deposits which banks mobilise from the public. The importance of deposits in **mortgage funding** has increased over the past 10 years, while that of bond issues has decreased. The Swiss financial sector features two institutions which issue mortgage bonds on behalf of domestic banks. However, these "Pfandbrief" institutions play only a minor role in the refinancing of mortgage loans.

Direct **government participation** in the housing market is negligible, with federal, cantonal and municipal administrations owning less than 4% of total residential units. Government participation in the banking sector is stronger due to state ownership of cantonal banks. Explicit state guarantees reduce the refinancing costs of cantonal banks. However, developments in market shares over the past 10 years suggest that this has not led to any significant advantage of cantonal banks over their regional competitors in the mortgage market.

Taxation in Switzerland does little to encourage home ownership. Housing is treated as an asset subject to both wealth and (imputed) income tax. A revision of federal taxation law which foresaw the elimination of imputed rent and housing value taxation was rejected in 2004. Taxation of capital gains varies between cantons. In some cantons, short-term capital gains are subject to a penalty tax in order to counter speculation in the housing market.

Legislation introduced in the 1980s and 1990s increased the role of private pension accounts in the social security system. **Pension fund** regulation encourages home ownership by allowing households to withdraw mandatory private funds and tax-exempted savings for property acquirement.

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[1] International Research and Technical Assistance.

[2] In this note, we refer to regional banks, savings banks and Raiffeisen banks as "regional banks".

Federal **guarantees** have been introduced over the past 10 years, with the objective of encouraging home ownership among households who do not meet banks' equity requirements. So far, however, the guarantee system has reached only few households.

1.2 Policy issues

Moderate recent house price increases, conservative loan-to-value ratios and a gradual increase in the volume of mortgages all suggest that **financial stability** in Switzerland is currently not threatened by developments in the housing finance market. House price developments have, however, been stronger in some regions of the country, possibly pointing to some regional overheating.

Despite the increasing competition between banks for mortgage borrowers, their lending standards do not seem to have fallen. Nevertheless, the increasing dominance of fixed rate mortgage contracts raises questions related to the risks to which banks are exposed:

- Does the increase in fixed rate mortgage contracts imply that indirect interest rate risk, ie interest rate induced credit risk, is becoming a less important issue for financial stability?
- Given the dominance of deposits in credit funding, does the increase in fixed rate contracts imply that the Swiss banking sector could be increasingly exposed to direct interest rate risk?

2. Background note

2.1 The Swiss housing market

Nearly two thirds of all **residential units** in Switzerland are rented. However, the percentage of owner-occupied units has increased slightly over the past decade. In particular, there has been a strong increase in private ownership of apartments and shared ownership of houses. Despite the fact that most households are not owner-occupiers, the housing market is still dominated by private persons. This suggests a strong concentration of private property ownership and widespread buying to let. Table 1 shows that institutional owners (pension funds, real estate funds) and cooperative societies play only a secondary role in the housing market. The direct participation of the federal, cantonal and municipal administration in the market for residential units is negligible.

Table 1

Residential statistics 1990/2000

	1990	**2000**
Residential units (in thousands)	2,800	3,028
Owner occupation	31%	35%
Ownership of rental units (in per cent):		
Private	51.5	57.5
Institutional	28.7	22.2
Cooperative	7.5	7.9
State	3.7	3.4

Source: Federal Statistics Department.

Since 1985, **prices** of houses and apartments in Switzerland have increased by a mere 1.5% per year, while average CPI inflation was 1.9% and nominal GNP rose by an average of 3.5%. The housing market has, however, seen a strong variation in house price development during this period. Table 2 shows that the market experienced a real estate boom at the end of the 1980s. This was followed by a marked decline in housing prices throughout the 1990s. The market stabilised in 1999, and housing prices have been recovering moderately since then.

Table 2

Housing prices 1985-2004

	Average increase per year		
	Housing prices[1]	**Consumer prices**	**Nominal GNP**
1985-1989	9%	2%	6%
1990-1994	–2%	4%	4%
1995-1999	–3%	1%	2%
2000-2004	2%	1%	2%
1985-2004	**1.5%**	**1.9%**	**3.5%**

[1] Prices for single-household units; source: Wuest & Partner.

2.2 Mortgage lending and funding

In Switzerland, mortgage loans can be offered by banks, insurance companies and pension funds as well as by the state and parastatal companies. The overwhelming majority of mortgages are provided by the banking sector. In 2002, over 90% of mortgages were provided by banks, increasing their share slightly from 87% in 1993. In this note, we concentrate our analysis on the lending and funding activities of the banking sector. The volume of mortgage lending by the banking sector in Switzerland has increased moderately over the past 10 years. Table 3 shows that nominal lending has increased by 32% since 1994, implying an increase in real mortgage volume of 24%.

The domestic banking sector in Switzerland is dominated by three categories of banks. The two nationwide banks together have 38% of total domestic assets (end-2004). State-owned “cantonal” banks (30% of total assets) and regional banks (19%) make up the other two main bank categories in the country. **Housing finance is the major domestic activity** of the banking sector, comprising 61% of domestic assets in 2004. Mortgages make up 54% of domestic assets for the two large banks, 71% for the cantonal banks and 81% for regional banks.

The housing finance market is quite evenly split between the three main banking groups in Switzerland. Over the past decade, regional banks have gained significant shares in the market. This is due to a shift of large banks away from mortgage lending in the aftermath of the real estate boom of the 1980s. Table 3 shows that **concentration** in the housing finance market is lower than that for other domestic credit. Non-mortgage lending to private households and non-financial enterprises is dominated by the large banks and cantonal banks, while the regional banks play only a minor role.

Table 3

Domestic lending 1994/2004

	Mortgage lending		Other domestic lending
	1994	**2004**	**2004**
Total (CHF millions)	425,803	587,360	136,386
Percentage lent by:			
Large banks	40%	34%	41%
Cantonal banks	36%	35%	27%
Regional and Raiffeisen banks	19%	24%	10%
Foreign banks	1%	1%	13%

Source: Swiss National Bank.

The Swiss banking sector displays hardly any **foreign linkages** when it comes to housing finance. Foreign banks play a negligible role in the Swiss housing finance market, with just 1% of domestic mortgage assets. As Table 4 shows, this contrasts strongly with their position in other segments of the domestic credit market, where they command 13% of assets. Moreover, while Swiss banks have a strong presence in foreign financial markets, this does not apply to housing finance. In 2004, 61% of the banks' assets related to cross-border activities. However, mortgages made up less than 1% of the total foreign assets of Swiss banks.

In Switzerland, domestic credit is predominantly funded by deposits. Table 4 shows that the importance of bonds in refinancing domestic credit has fallen significantly over the past decade. The Swiss financial sector features two institutions which issue **mortgage bonds** on behalf of domestic banks. These "Pfandbrief" institutions are subject to special regulation by the Federal Banking Commission. One of these institutions is jointly owned by the cantonal banks, while the other is jointly owned by the two large banks and over 200 regional banks. As Table 4 shows, however, mortgage bonds play only a minor role in the refinancing of mortgage loans.

Table 4

Funding of mortgages 1994/2004

Domestic liabilities in % of domestic mortgages	**2004**	**1994**
Deposits	104%	105%
Bonds	13%	34%
Mortgage bonds	8%	7%

Source: Swiss National Bank.

2.3 Contract types and interest rates

Household borrowing in Switzerland has traditionally been dominated by **mortgage borrowing**, while consumption borrowing plays a negligible role. This role of mortgage borrowing in the domestic financial market has not changed over the past decade. Mortgage loans still make up 90% of total household borrowing.

Swiss households can choose from a wide range of **mortgage contracts**. Banks traditionally offered contracts with either fixed or variable interest rates. Over the past 10 years, lenders have begun to introduce new contract types which mix the features of the two traditional products. Currently, variable contracts are available with rates pegged to Libor and/or upper and lower caps. Moreover, some lenders have introduced contracts with a portfolio of fixed rate obligations with staggered maturity. Table 5 shows that the share of fixed interest contracts has increased strongly over the past decade. In 1994, less than a quarter of all mortgages were based on fixed interest rate contracts. Today, the share of fixed rate contracts amounts to more than two thirds of total mortgage loans. Fixed interest contracts are available for a term of two to 10 years, and borrowers who terminate fixed interest rate contracts in advance must pay a prepayment penalty.

Owner-occupiers seeking mortgage loans must provide at least 20% equity participation, while minimal equity for buy-to-let borrowers and holiday home buyers is even higher. Interest-only loans are available for up to 65% of the property value. Borrowing in excess of this threshold is subject to amortisation. Lenders typically demand yearly repayments of 1% of the initial loan size, so that borrowing in excess of the 65% threshold is amortised within 15 years. Given lenders' conservative lending practices, the **loan-to-value ratio** (LTV) is low in Switzerland. As Table 5 shows, the overwhelming majority of mortgages display an LTV ratio of less than 2/3.

Table 5

Mortgage borrowing from banks 1994/2004

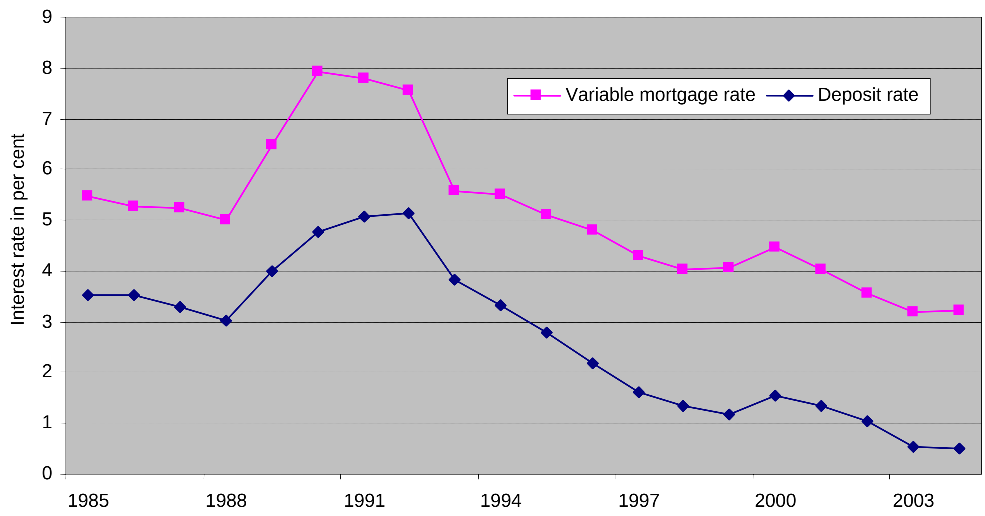
	2004	1994
Percentage by private households	76%	71%
Percentage of mortgages with fixed interest rates	72%	24%
Percentage of mortgages with LTV less than 2/3	91%	93%

Source: Swiss National Bank.

At the end of 2004, interest rates for variable mortgages stood at 3.2%, their lowest value ever. Over the past 20 years, nominal mortgage rates have fluctuated strongly, rising at the end of the 1980s to a high of 8% and falling ever since. The margin yielded by banks on mortgages (mortgage rate minus deposit rate) has remained quite stable over the same period. As one indicator for this, Graph 1 shows that the margin between the variable mortgage rate and deposit rate has on average been 2.5% since 1985, reaching its highest level of 3.1% in 1990 at the height of the housing price boom.

Graph 1

Interest rates 1985-2004



Source: Zürcher Kantonalbank.

2.4 Government influence

While the state is hardly involved in the provision of residential units, the cantonal administrations are strongly involved in the financial market as owners of the cantonal banks. Moreover, regulation and taxation at the federal, cantonal and municipal levels have a considerable impact on the housing and housing finance market.

Government participation in the banking sector is widespread, with state ownership of **cantonal banks**. Explicit state guarantees reduce the refinancing costs of cantonal banks and could provide them with advantages over their competitors in the housing finance market. However, an analysis of pricing strategies[3] and the developments in market shares (see Table 3) suggest that this is not the case.

Taxation of housing does not encourage housing demand as property is treated as an asset subject to both wealth and (imputed) income tax. Net property capital (market value minus mortgage loan) is subject to wealth tax. Imputed rental income, net of interest payments and renovation costs, is also subject to income tax, with taxation differing amongst cantons. Some cantons allow deductions for principal residences or selected groups (first-time buyers, pensioners, low-income households).[4] Capital gains are subject to cantonal income taxation,[5] with rates varying by duration of ownership. In some cantons, short-term capital gains are subject to a penalty tax in order to counter speculation in the housing market. Property buyers also have to pay a transaction tax to cantonal authorities.

Home ownership is further discouraged by federal regulation providing strong **protection of tenants** in rental housing units. Tenants are protected against eviction by landlords. Moreover, they are protected against rental increases, which must be justified by cost increases on the part of the landlord. The security provided to tenants through this legislation encourages households to rent rather than own their home.

However, home ownership is encouraged by federal **pension fund regulation**. Mandatory individual pension accounts can be withdrawn for the purpose of buying residential property. Moreover, voluntary payments to pension funds are income tax-exempted and can be subsequently withdrawn to buy residential property. New legislation on the use of mandatory and voluntary pension funds in the 1980s and early 1990s seems to have contributed to the recent increase in owner-occupation.

The federal administration also offers **guarantees** to households which do not meet the equity requirements of the banking sector. So far, however, federal guarantees have played an insignificant role in encouraging home ownership in Switzerland. The two coperatives which channel guarantees to households have issued only 300 guarantees since 1992.

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[3] R Bichsel and C Spielmann, "State-owned banks as competition enhancers, or the grand illusion", memo, Swiss National Bank, 2004.

[4] Note that both income and wealth tax are collected at the federal, canton and municipal levels. Federal taxation of imputed rent is harmonised across cantons, while canton-specific taxation differs.

[5] In some cantons, a special property gains tax rather than income tax is collected in order to prevent progressive taxation of other income.