Niklaus Blattner: Switzerland's real estate market

Introductory remarks by Mr Niklaus Blattner, Vice-Chairman of the Governing Board of the Swiss National Bank, at the end-of-year media news conference, Zurich, 15 December 2005.

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Competition in the Swiss real estate market has undoubtedly become stiffer in recent times. This is basically a good thing. Moreover, different market players and other observers have been pointing out for some time now that banks have not only become more competitive, but also less cautious.

Mortgage lending is part of the banks' core business. The Swiss National Bank (SNB) therefore decided to analyse the current situation and development in the Swiss real estate market in more detail. The SNB is mandated to contribute to the stability of the financial system. The question asked was the following: Are there any signs that the fiercer competition in the real estate market is associated with excessive risks which may ultimately threaten the stability of the banking system?

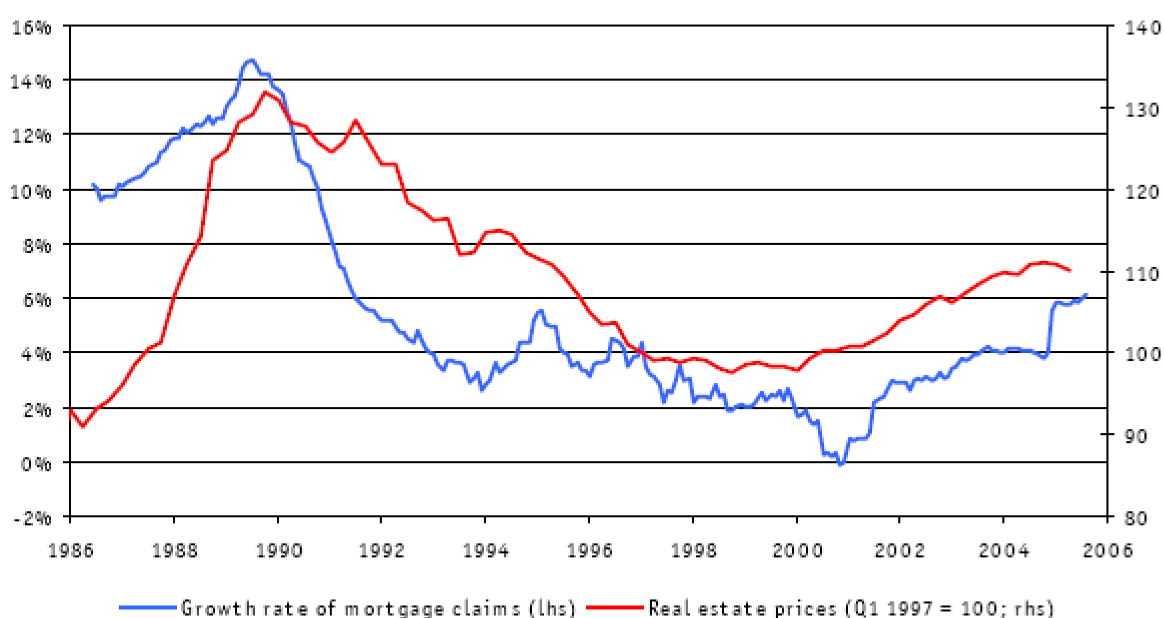
The National Bank's analysis is based on both statistical data regarding banking activity and on the results of a survey conducted among a number of banks specifically for this purpose. The random sampling covers banks with a total market share of over 70%.

The main result of our survey shows that stronger competition in the real estate market has so far not had a destabilising effect on the banking sector in Switzerland.

Modest rise in Swiss real estate prices overall

Among other things, our assessment is based on the development of real estate prices. In Switzerland as a whole, real estate prices have only experienced a moderate rise in the past few years. Moreover, the general price level is still considerably lower than the record highs reached over ten years ago. By contrast, owner-occupied apartments are an interesting deviation from this trend. They have risen sharply of late, almost equalling their 1990 high.

Econometric estimates of equilibrium prices which have been additionally carried out also fail to indicate any overheating in the Swiss real estate market as a whole. We arrive at the same conclusion even under the assumption of a significantly higher interest rate level than today's, which would result in a marked correction of the capitalised value of real estate. Our assessment is based on an observation for Switzerland as a whole. It does not exclude the possibility that there have been excesses in individual regions or in certain parts of the real estate market.



Graph 1: Development of mortgage claims and real estate prices
Source: SNB, Wüest & Partner

No sign of banks taking greater risks

Since the end of 2002, mortgage claims have recorded annual growth rates of up to 6%. This is quite substantial compared with the rather moderate trend in real estate prices. It appears that the expansion of mortgage claims has not been driven so much by real estate prices, but by the number of loan requests. Consequently, the growing demand for loans is more likely attributable to factors other than the expectation of a speculative boom in real estate prices.

The crucial question is the following: Is the higher demand for loans due to excessively harsh competition among banks that has led to cheaper credit not reflecting the actual risks incurred?

How has the relatively strong growth in mortgage loans impacted on bank risks? To answer this question, we took a closer look at the banks' risk behaviour. Several indicators led us to believe that banks have hardly engaged in excessive risk taking.

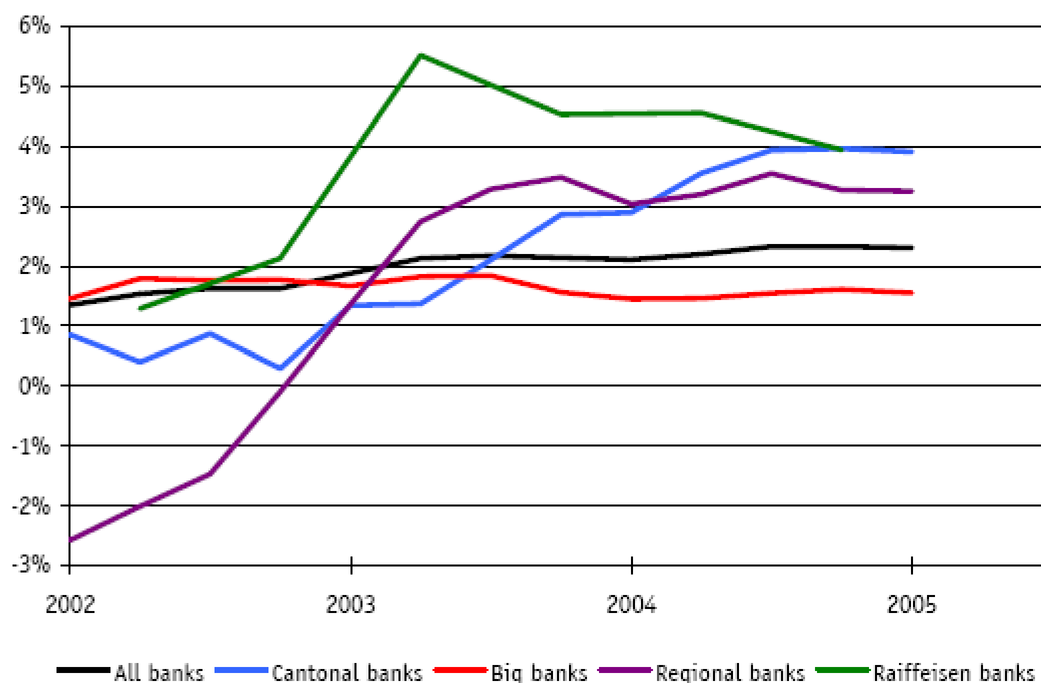
While it is true that interest rate margins, i.e. the spreads between mortgage rates and the banks' financing costs, had fallen slightly by mid-2005, other bank expenses declined at the same time. In the final analysis, therefore, the profit margin was virtually constant or even slightly higher. The profit margin corresponds to the difference between the interest rate margin and the total operating expenses expressed in percent of the loan volume and – to reflect expected risks – of total value adjustments and provisions. The banks' profit margin thus also serves to cover unexpected risks. Given that the profit margin has remained constant or moved slightly higher, the banks' risk-taking capacity has not diminished in spite of pressure on interest rate margins. This presupposes, however, that the banks have made realistic value adjustments and provisions. We currently assume that this is the case.

Moreover, average lending limits for mortgage loans have changed only insignificantly and may be regarded as cautious. For instance, the proportion of low-risk first mortgages – i.e. those mortgages with the lowest lending limit – is over 90%. The criteria used in extending loans can also be rated as conservative. As a rule, assessments of a debtor's future solvency are based on considerably higher interest rates than the current ones. Mortgage debtors should therefore be able to meet their liabilities even if there is a marked increase in the interest rate level.

Our analysis focuses on system-relevant banks and on different groups of banks. We rely on aggregated data and on a random sampling of banks or groups of banks. Problems with individual institutions cannot be excluded but should not threaten system stability.

Increase in interest rate risks

These assessments, which have so far been positive, are becoming slightly clouded because of higher interest rate risks. Smaller banks in particular have seen a relatively strong increase in direct interest rate risks. A sharp rise in the interest rate level could affect the valuation of assets and liabilities of such banks to such an extent that their capital resources would in some cases be reduced considerably. While such losses could still be absorbed, we would, however, consider a further rise in interest rate risks as critical.



Graph 2: Interest rate risks by bank groups
(reduction in net present value as a percentage of equity following an interest rate shock of +100 basis points)
Source: SNB

Conclusion: Increased efficiency without higher risks

The slight narrowing of interest rate margins supports the assumption of increasingly fierce competition in the mortgage market. From the viewpoint both of consumers and of economic efficiency, this would be a welcome development. However, in the banking business there is always a danger that fiercer competition might encourage excessive risk taking by the banks. A bank can outperform its competitors by offering more favourable conditions while at the same time accepting poorer risk cover. However, as already mentioned, our aggregated analysis suggests that caution has not waned. Banks' gross margins are declining slightly because their cost savings and improvements in efficiency are being passed on to customers. The capacity to absorb risks is not compromised by granting customers better conditions. Currently, the positive aspects of healthy competition are taking hold without apparently having any negative side effects.

The SNB will nevertheless keep a close watch on trends in the real estate market. In particular, we will monitor interest rate risks, which have already reached a high level.

With an appropriate normalisation of money market rates, the SNB contributes to limiting the danger of an abrupt rise in interest rates. In the current environment of historically low rates, however, there is no guarantee that the future trend in interest rates will be moderate. Sharp fluctuations in market rates are a possibility. This is a fact banks must bear in mind when managing interest rate risks.