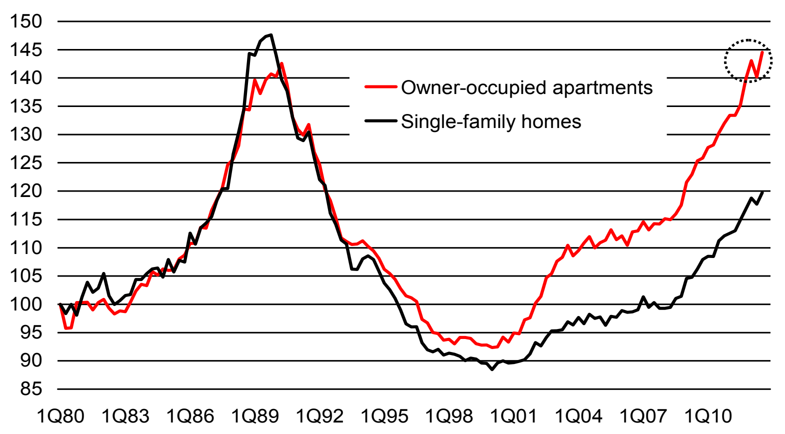
Swiss housing: build up of medium-term risks triggers activation of capital buffer

- The SNB today initiated an activation of the newly available countercyclical buffer at a level of 1% of risk-weighted residential mortgage loans, in order to achieve a preventive effect on housing market dynamics, which continued almost unabated in 2H12.
- Looking at the long-term trend in important housing indicators and a comparison with recent bubble countries doesn't, however, point to excessive levels yet.
- But still, medium-term risks are continuing to build, not least as the tax regime favors high mortgage debt levels. This means disproportionate leverage for financing costs: driven by ultra-low interest rates, the debt service ratio has fallen to a new record low lately. A 2pp higher rate level would, however, more than double the burden on households.

Housing market dynamics remain strong

The recently strengthened confidence in the euro also helped to ease the pressure on EUR-CHF. Since last month, the exchange rate has been trading visibly above the minimum target rate of 1.20. Although the currency situation will undoubtedly remain the SNB's monetary policy priority and any interest rate normalization is not in the cards in the foreseeable future, the more relaxed FX situation gives the central bank officials more room to sharpen their rhetoric towards housing-market risks. All three board members repeatedly stressed that housing market dynamics are worrying. Anecdotal evidence of a slowdown, observed in spring last year, was not confirmed in the second half of 2012. The strong expansion in mortgage lending continued almost unabated, well above nominal GDP growth, with an annual rate of 4.6% in November. And, preliminary annual 2012 house price data didn't indicate a slowdown in the second half of the year, either (see chart 1).

SWISS REAL HOUSE PRICES, INDEX (1Q80=100)



Source: SNB, UniCredit Research

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Overheating Barometer not in high alert mode yet

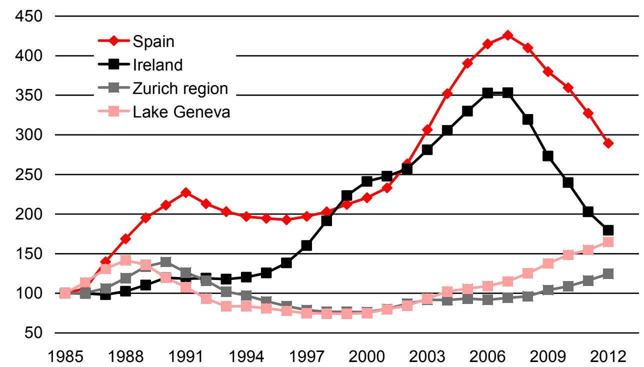
So how big is the bubble risk on the Swiss housing market at the beginning of 2013? To get straight to the point, our UniCredit Overheating Barometer still doesn't show a high alert level. Although most of our five single indicators have deteriorated further throughout 2012, only the relatively low Affordability Index sends a warning signal[1]. But thanks to the ultra-low interest rate level, the Affordability Index is still more favorable than before the start of the house price boom, despite the strong upward trend in prices (see table 1). In addition, if one considers only the average price level for apartments, which exhibit the most pronounced price increases but still cost substantially less on average than single-family homes, the current Affordability Index value even remains above the 100 threshold. Overall, our barometer in no way indicates similar risks to those, for example, in Spain or Ireland at the peak of the boom before the financial crisis (see table 1). Therefore, we do not rate the continuously strong performance of the Swiss housing market as excessive thus far. (For details on our Overheating Barometer please see *UniCredit Global Themes Series: European Housing – Fundamentals and policy implications*, March 2012.)

This assessment also holds true when looking at price developments in the boom regions Zurich and Lake Geneva. Although price levels there may no longer be fully explained by fundamentals, as suggested by SNB president Thomas Jordan in the last monetary policy statement, again the dynamics remain much more muted than in recent bubble countries (see chart 1). Furthermore, although price levels are elevated, they do not appear exceptional compared to other international thriving metropolitan centers.

Table 1: UniCredit Overheating Barometer

	Spain 2006	Ireland 2006	Switzerland 2006	Switzerland 2012
Price to income ratio	1.5	1.8	-0.4	0.8
Price to rent ratio	1.6	1.3	-0.4	0.5
Affordability Index	99	98	89	96
Oversupply ratio	1.3	1.6	0.1	0.2
Mortgage debt gap	4.9	6.2	1.2	2.3
Overheating Barometer (0-5)	5	5	1	1

Chart 1: Real house prices, Index (1985=100)



Source: BIS, Feri, SNB, UniCredit Research

Higher medium-term risks due to elevated debt ratio

The current situation – which is still relatively controlled, in our view – does not, however, mean that the market does not require the attention or action of regulators. The record-low interest rate level and the robust labor market situation, as well as high immigration, deliver ongoing strong tailwinds for housing demand. If, driven by these support factors, price rises continue at the current pace, medium-term risks will gradually continue to build. In this respect, a special feature of the Swiss mortgage market increases the risk potential. Unlike in almost all other countries, the Swiss income tax regime provides an incentive to keep mortgage indebtedness at an elevated level, as households can deduct interest payments

[1] The threshold levels for the indicators are defined as follows: for the price-to-income, the price-to-rent, and the housing supply to household growth ratio, one standard deviation above the long-term average. For our affordability measure, the index value 100. And for the mortgage debt ratio, a 4pp overshooting of its long-term trend, calculated via the Hodrick-Prescott filter method.

from imputed rental income on owner-occupied housing. Recently, only in the Netherlands has a similar tax treatment been in effect. Both countries therefore show an extraordinarily high mortgage debt-to-household income ratio (see chart 2). In the Netherlands, mortgage lending has likely been additionally boosted by the intensive use of mortgage securitization, which is not the case in Switzerland.

Switzerland is one of the world's most wealthy nations and, accounting for household assets, net indebtedness is on average substantially lower than in other countries. Nevertheless, the inflated mortgage volumes mean increased risk for the financial sector in the case of a severe economic deterioration and subsequent strongly rising unemployment, which, even in the safe-haven country of Switzerland, can not be excluded. Already in the early 1990s a recession following a housing and mortgage boom triggered massive write-downs of more than CHF 40bn, which back then accounted for a substantial 8.5% of the outstanding mortgage volume, not much below the peak levels observed in the wake of the recent housing recessions in the US and Ireland.

Moreover, due to the high debt level, rising interest rates have a higher leverage on debt service costs. There is no room and no need for the SNB to begin interest rate normalization in the foreseeable future, but eventually economic developments will make a departure from the zero-interest rate policy necessary. Despite the higher mortgage volume than in other countries, the extraordinary low mortgage rates currently keep the Swiss debt service ratio (interest expenditure as a percentage of disposable household income based on market rates for two-year fixed loans) at a historical trough of just above 2%. A rise in the interest rate level by 2pp would, however, more than double the debt service ratio (see chart 3). Household surveys suggest that a significant share of home buyers would have difficulties meeting mortgage interest payments in this scenario. The higher share of fixed-rate mortgages in Switzerland would lead to a more gradual adjustment than elsewhere – especially in Ireland and Spain, where the bulk of mortgages are based on variable interest rate contracts – but overall the leverage in other European countries is substantially lower (see chart 3).

Chart 2: Household mortgages as a % of disposable income (2012f)

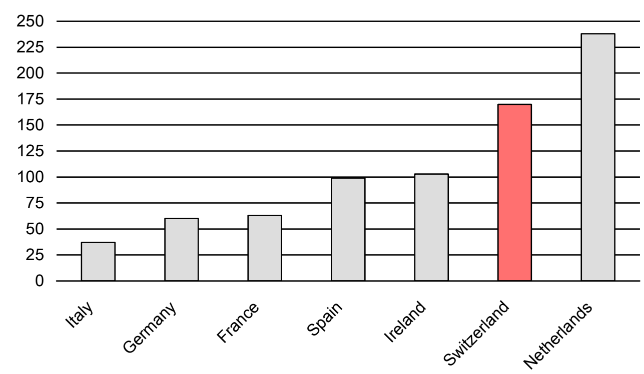
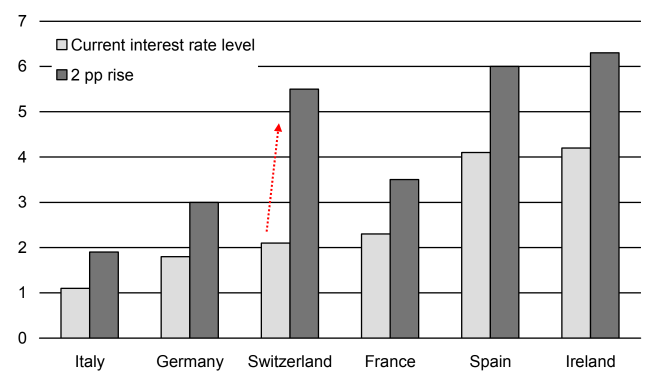


Chart 3: Debt service ratios, in %



Source: ECB, SNB, EMF, UniCredit Research

Policymakers take counter-measures

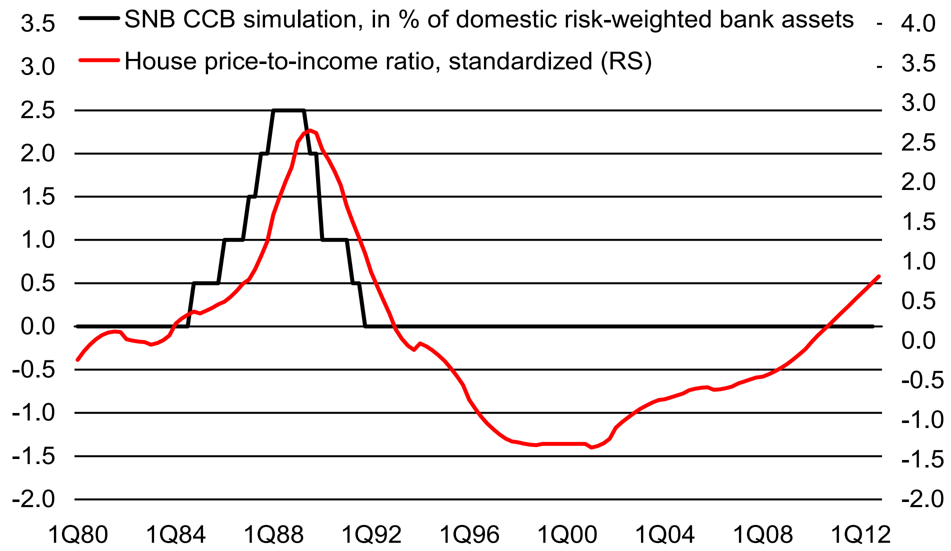
Although Swiss politicians have so far been unable to push through a change to the distortive tax rule, other measures have been introduced. Under the guidance of regulators, Swiss banks strengthened their minimum requirements for mortgage lending. First, since July 2012 new mortgages with an equity share of less than 10% of the collateral value are subject to higher capital requirements. Second, mortgages now have to be amortized to two-thirds of the collateral value within 20 years. In addition to tighter capital rules and bank self-regulation, the SNB conducts quarterly surveys among banks and has the possibility since the middle of last year to ask for an activation of a countercyclical buffer (CCB). The CCB is a pre-emptive measure that requires banks to build up capital gradually as imbalances in the credit market develop. The maximum level is 2.5% of domestic risk-weighted bank assets. There is no conclusive empirical evidence regarding the impact of macroprudential measures aimed at cooling down housing credit booms. In the past, it has mainly been emerging countries that have adjusted regulatory structures in this way, but a recent comprehensive IMF survey confirmed that, in particular raising the minimum capital adequacy ratio (CAR) was followed by a significant deceleration in house price dynamics, which bodes well for the CCB[2].

Last year, the SNB still refrained from asking for cyclical capital requirements for mortgage lending. It announced it would not take any action at least until the end of 2012. But SNB vice-president Jean-Pierre Danthine had to acknowledge in the December monetary policy statement that on average the banks' readiness to take mortgage risk had not changed significantly during the second half of 2012. Consequently, it came as no big surprise that the SNB announced this morning that it had asked the Swiss Federal Council (Bundesrat) to activate the CCB. The proposed capital buffer is targeted at residential mortgage loans for Swiss properties. The initial level will be 1% of related risk-weighted positions, and the deadline for compliance is 30 September 2013. The SNB stated in its rationale that it already sees imbalances on the housing market that pose a considerable medium-term risk to the stability of the Swiss banking sector and the economy. In order to achieve the desired preventive effect, early activation of the CCB is essential. With respect to the level, the proposed 1% of risk-weighted assets in the residential mortgage loans segment remains well below the maximum 2.5% of total domestic risk-weighted assets. According to the SNB, this reflects the fact that the current imbalances are still smaller than those immediately prior to the onset of the past real estate and banking crisis. The SNB will regularly assess the need to either adjust the level of the CCB, or deactivate it.

Last year, the SNB published an illustration of a discretionary approach for setting the CCB, based on historical data, guided by measures summarizing the dynamics of domestic residential property prices[3], showing a hypothetical path for changes in the CCB during the late 1980s and early 1990s. A simple comparison of the CCB simulation with the long-term house price-to-income ratio presents a rather good fit, with the CCB series running ahead as expected (see chart 4 on next page), confirming the need for today's decision.

[2] Vandenbussche et al. (2012), *Macroprudential policies and housing prices*; IMF Working Paper WP/12/303
[3] SNB (2012), *Implementing the countercyclical capital buffer in Switzerland*, Berne, June 2012

CHART 4: BASED ON PAST EXPERIENCE ACTIVATION OF CCB IS INDICATED



Source: SNB, BfS, UniCredit Research

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